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Fundamentals of Federal Income Taxation of Natural Resources

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FUNDAMENTALS OF FEDERAL INCOME TAXATION OF NATURAL RESOURCES

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INTRODUCTION

Federal income taxation of natural resource extraction is often perceived to be an arcane and specialized area of law. Nevertheless, an understanding of the fundamental principles of federal income taxation of natural resources is essential for any lawyer practicing "mineral" or "oil and gas" law. Tax consequences are a driving force behind the structure of many transactions involving natural resources, influencing both the form of the transaction by which mineral interests are transferred and the form of the organization through which taxpayers join together to pursue the development and exploitation of a mineral deposit.

Almost all of the provisions of the Internal Revenue Code and common law tax doctrine peculiar to natural resources spring from taxpayers' quests to maximize the available depletion allowance deduction. Section 611 of the Internal Revenue Code [herinafter I.R.C.] provides that, "[i]n the case of mines, oil and gas wells, other natural deposits, and timber, there shall . . . be a reasonable allowance for depletion . . . according to the peculiar conditions in each case. . . ." This deceptively simple phraseology masks the enormous complexities introduced by percentage depletion under I.R.C. § 613 and, for oil and gas wells, under I.R.C. § 613A. The complexity of computing percentage depletion is the mere tip of an iceberg, however, since the depletion deduction allowable for each taxable year is the greater of percentage depletion and cost depletion. This schizoid feature of the depletion allowance compounds the complexity. Finally, the complexity is magnified even further by the regulations' requirement that taxpayers who produce and sell minerals, oil, and gas (i.e., owners of a working or operating interest) capitalize all depletion allowances, even percentage depletion in excess of otherwise allowable cost depletion, under the "uniform capitalization rules" of I.R.C. § 263A. *See* Temp. Reg. § 1.263A - 1T(b)(2)(iii)(K).

Percentage depletion, simply stated, is a tax allowance (which prior to the enactment of I.R.C. § 263A in 1986 was a deduction) equal to a percentage of income from a mine or well. Cost depletion, on the other hand, is an allowance, entering into cost of goods sold for an operating interest and treated as a deduction for nonoperating interests, for a portion of the cost or basis of the mine or well. Because entitlement to percentage depletion is unrelated to basis, and no additional cost recovery is allowed, the common preference of taxpayers to deduct currently an expense associated with a capital asset, rather than capitalize it as part of basis, is intensified when the expenditure relates to a mine or an oil or gas well. If percentage depletion can be expected to be consistently claimed, a taxpayer will never effectively receive a deduction for a cost added to the basis of a mine or well. On the other hand, because percentage depletion is limited to fifty percent of taxable income from a mine or well property, current deductions during a year in which there is production may reduce the depletion allowance. Thus, taxpayers have an inducement to attempt to avoid associating "excessive" current deductions with a mine or well. Taxpayer desire to maximize both depletion deductions and current deductions, results in complex planning problems. Congress, however, has provided substantial assistance in the form of preferential tax treatment for many of the capital expenses associated with the acquisition of mine and oil and gas properties.

Many expenditures that would be capitalized if treated in the same manner as analogous expenditures in other industries, may be currently deducted when incurred by taxpayers involved in the extraction of natural resources. Both mining and oil and gas share, although under different but analogous provisions, a preferential deduction for the costs of preparing for extraction — costs that are clearly capital costs analogous expenditures in other industries are capitalized. Mine development expenses are currently deducted under I.R.C. § 616 and oil and gas drilling expenses are largely deducted under I.R.C. § 263(c). Mine exploration costs are also currently deductible under I.R.C. § 617, but this deduction is actually a timing provision, that ultimately allows no deductions in addition to depletion. None of these provisions are subject to the uniform capitalization rules of § 263A, *see* I.R.C. § 263A(c)(3); and all of these provisions are considered by the Department of the Treasury to be tax expenditures, not normative provisions appropriate for the purpose of computing taxable income. *See* e.g., *Budget of the United States Government*, Fiscal Year 1985 (Special Analysis G). In addition, mine closing costs may be currently deducted under the very complex provisions of I.R.C. § 468, rather than capitalized or deducted when actually incurred.

I. THE DEPLETION ALLOWANCE

A. Purpose of the Depletion Allowance

Originally, the purpose of the depletion allowance was to allow a taxpayer a tax free recoupment of his investment in a mineral deposit in recognition of mineral deposits as wasting assets. In *United States v. Ludey*, 274 U.S. 295, 301 (1927), the Supreme Court analogized the depletion allowance to the cost of goods sold. While this is quite true regarding cost depletion, it is an entirely erroneous view of percentage depletion, the ancestor of which — discovery value depletion — was first enacted in 1918, expressly to stimulate prospecting and exploration for minerals. This was acknowledged by the Supreme Court in *United States v. Swank*, 451 U.S. 571, 576 (1981), when it stated:

> Because the deduction is computed as a percentage of his gross income from the mining operation and is not computed with reference to the operator's investment, it provides a special incentive for engaging in this line of business that goes well beyond a purpose of merely allowing the owner of a wasting asset to recoup the capital investment in that asset.

Subsequently, in *Commissioner v. Engle*, 464 U.S. 206 (1984) the Supreme Court reaffirmed that the incentive purpose of percentage depletion is of great relevance in interpreting the statute for purposes of determining entitlement to the depletion allowances. Percentage depletion provides an incentive, however, only to the extent that it exceeds cost depletion. Thus, in the annual Budget of the United States Government, in Special Analysis G, only the excess of percentage depletion over cost depletion is denominated as a tax expenditure.

As noted above, under I.R.C. § 263A and Temp. Reg. § 1.263A - 1T (b)(2)(iii)(K), both cost depletion and percentage depletion, even if in excess of cost depletion, must be capitalized by an operator as inventory costs. As far as cost depletion is concerned, this treatment is entirely proper. Even before the enactment of I.R.C. § 263A, the regulations in Treas. Reg. § 1.471-11(c)(2)(iii)(b) required that cost depletion be treated as an inventory expense if it was so treated for financial accounting purposes. Furthermore, Treas. Reg. § 1.61-3(a) and § 1.471-11(c)(2)(iii)(b) provide that gross income is to be determined without subtraction of the depletion allowance based on a percentage of income to the extent that it exceeds cost depletion, which may be required to be included in the amount of inventoriable costs. Thus, even that portion of percentage depletion that equals cost depletion may have been an inventoriable cost, rather than a deduction, prior to the enactment of I.R.C. § 263A. This was entirely proper from a theoretical perspective.

Requiring capitalization of percentage depletion in excess of cost depletion, however, as required by the regulations under I.R.C. § 263A, appears to conflict with the tax expenditure purpose of allowing percentage depletion; and to the extent that the regulations require the capitalization of percentage depletion in excess of cost depletion, they may conflict with the statute. This conclusion is reinforced by the near impossibility of computing percentage depletion as anything other than a current deduction because of the limitation of percentage depletion to fifty percent of the taxable income from the property, and in the case of oil and gas the further limitation to sixty-five percent of taxable income.

B. Computation of Depletion Allowance Deduction

1. Generally

The depletion allowance for a taxable year is the greater of the amount computed under the cost depletion method or the percentage depletion method. I.R.C. § 613(a). A separate computation is necessary for each "property" as defined in I.R.C. § 614. The taxpayer's basis in the mineral deposit is reduced by the greater of the amount of the depletion allowance claimed or the depletion properly allowable for the year. I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(b). Both cost and percentage depletion are subject to reduction under I.R.C. § 617(b)(1)(B) for "recapture" of previously deducted, solid mineral exploration expenses. Aggregate percentage depletion deductions claimed in an amount in excess of the unadjusted basis of the deposit do not reduce the basis of the property below zero. Rev. Rul. 75-451, 1975-1 C.B. 330.

2. Cost Depletion

Cost depletion is computed by deducting an appropriate portion of the basis of the mineral property for each unit extracted and sold. Treas. Reg. § 1.611-2(a)(1). The formula in the regulations provides that the adjusted basis of the mineral property at the end of the taxable year, including all adjustments to basis except depletion, is to be divided by the sum of the number of units estimated to remain at the end of the taxable year (including units extracted but not sold) plus the number of units extracted and sold during the year.

This result, termed the "depletion unit" is multiplied by the number of units sold to yield the cost depletion allowance. When the basis of the mineral property has been reduced to zero, cost depletion ceases, even if recoverable reserves remain.

Units sold during the taxable year are determined with reference to the taxpayer's method of tax accounting. Treas. Reg. § 1.611-2(a)(2). Taxpayers reporting on the cash method include units for which payment was received during the year, regardless of the year of production or sale. *See* Treas. Reg. § 1.471-7. Accrual basis taxpayers should use their inventory method to determine the number of units sold. A taxpayer extracting and selling minerals should report on the accrual method. *See* Treas. Reg. § 1.471-1; Treas. Reg. § 1.446-1(c)(2)(i). Under I.R.C. § 448 all C corporations must report on the accrual method unless the corporation does not have more than $5,000,000 of gross receipts computed under a three year rolling average method.

Variations of this method are applied to certain payments received by holders of nonoperating interests. For a net profits interest, the annual depletion allowance is the taxpayer's basis in the property at the end of the year multiplied by the net profits payments received (or otherwise includable in income) for the year, divided by the sum of the net profits receipts for the year plus aggregate amount of net profits payments expected to be received in the future.

Dollar equivalents must similarly be used to compute cost depletion when a lease bonus or advance royalty is received. Treas. Reg. § 1.612 - 3(a)(1) provides that allowable cost depletion is the basis of the property immediately before the receipt of the payment, multiplied by the amount of the advance royalty or bonus, and divided by the sum of the advance royalty or bonus and aggregate royalties expected to be received in the future. Strict application of this formula in *Collums v. United States*, 480 F. Supp. 864 (D. Wyo. 1979), resulted in allowing the entire basis of the mineral interest to be recovered against a bonus in the year of receipt where the taxpayer established that there was no reasonable prospect of receiving future royalties. This result appears to be absurd, because depletion previously allowed with respect to a lease bonus must be recaptured into income if the lease is surrendered without production. Treas. Reg. § 1.612 - 3(a)(2). A similar rule requires recapture in whole or in part of depletion claimed with respect to advance royalties if a lease is surrendered prematurely. *See* Part IX.B.4, *infra*.

Cost depletion for production payments received is also computed with respect to dollars received, rather than units extracted, where the rights of the holder of the production payment are expressed in dollars rather than units of minerals. *See Vaccaro v. Commissioner*, 12 T.C.M. (P-H) ¶ 43,433 (1943), *appeal dismissed*, 33 A.F.T.R. (P-H) 1672 (5th Cir. 1944). Two different methods of computation, both based on the assumption that the production payment will payout in full, have been approved by the I.R.S. in Rev. Rul. 65-10, 1965-2 C.B. 3. The first method multiplies the basis of the property at the end of the period by the unpaid face amount of the production payment at the beginning of the period, divided by the proceeds received from the production payment during the period. Because this formula includes the interest element in a production payment in the computation base, it may be preferable to use the second method. Under this formula, cost depletion equals the basis at the end of the period multiplied by a fraction, the numerator of which is the principal amount of the production payment at the beginning of the year minus the principal amount of the production payment at the end of the year, and the denominator of which is the principal amount of the production payment at the beginning of the year. For the definition of a production payment, *see* Part II.B.6.(b), *infra*.

Several special rules regarding the input factors in these computations should be noted.

The basis of the mineral property under I.R.C. § 612 is the adjusted basis used for determining gain and loss under I.R.C. § 1011. Taxpayers must maintain a depletion account in which all adjustments to basis are recorded. Treas. Reg. § 1.612-2(b). The adjustments to basis required by I.R.C. § 1016 include depletion, *see* Treas. Reg. § 1.1016-2(a), (b), and the value of the "depletion unit" will change as a result of any loss or any addition to basis. All adjustments to basis in a particular year, other than the reduction for depletion, must be made before computing the depletion allowance. The depletion unit will also decrease as a result of claiming percentage depletion in any year.

To calculate cost depletion the taxpayer must estimate, "according to the method current in the industry and in light of the most accurate information obtainable," the number of units "reasonably known, or, on good evidence believed to have existed in place" at the close of the first taxable year of operation of the property. Treas. Reg. § 1.611-2(c)(1). For subsequent years, the number of units remaining generally will be the number of units remaining at the close of the prior year minus the number of units extracted and sold during the current year. Treas. Reg. § 1.611-2(c)(2).

If the estimate of the number of units remaining is revised, cost depletion deductions must subsequently be based on the revised estimate, I.R.C. § 611(a); Treas. Reg. § 1.612(c)(2), but the revised estimate will not be applied retroactively. *E.g., Kehota Mining Co. v. Lewellyn*, 30 F.2d 817 (3d Cir. 1929). Internal Revenue Manual § 363.3 provides that oil and gas reserves are to be determined as follows: "Reserves as of any date mean the number of units which are expected to be produced profitably subsequent to that date." On the other hand, where solid minerals are involved, Rev. Rul. 67-157, 1967-1 C.B. 154, held that a taxpayer was not entitled to a downward adjustment of recoverable reserves based on its analysis of trends in coal prices indicating that future prices would be less than the cost of extraction. The Revenue Ruling takes the position that all reserves classified as measured, indicated or inferred under Geological Survey Bulletin 1136, "Coal Reserves of the United States," must be included in the estimates of recoverable coal. It gives as an example of a situation warranting a reduced estimate the discovery of a pinch-out or geologic fault.

In *Trace Fork Mining Co. v. Commissioner*, 15 B.T.A. 872 (1929), the taxpayer was allowed to revise its estimate of recoverable coal reserves downward when the deposit was thinner and contained more shale than expected. *West Virginia Coal Co. v. Commissioner*, 16 B.T.A. 378 (1929), held that a downward revision of coal reserves was improper when the taxpayer stopped mining at a fault, which interposed rock between the mine and the remainder of the coal seam, because of a drop in market demand. However, in *Black Gold Petroleum Corp. v. Commis-*

sioner, 13 T.C.M. (P-H) ¶ 44,088 (1944), the taxpayer was allowed to make a downward revision in recoverable hydrocarbon reserves based on the lack of a commercial market for extracted gas.

Although reestimating recoverable reserve compels a change in the depletion unit, if the basis of the mineral deposit was originally determined by allocating a portion of the purchase price of the fee to the surface and a portion to the mineral property, the adjusted basis of the mineral property may not be revised. Treas. Reg. § 1.611-2(c)(2); Treas. Reg. § 1.612-2(f).

3. Percentage Depletion

(a) Generally

Percentage depletion is determined under I.R.C. § 613, subject to limitations of I.R.C. § 613A in the case of oil and gas wells. The applicable percentage as set forth in I.R.C. § 613(b) is multiplied by the taxpayer's gross income from the property, less rents and royalties paid with respect to the property. I.R.C. § 613(a); Treas. Reg. § 1.613-1. The applicable percentage is ten percent for coal, I.R.C. § 613(b)(4), and fifteen percent for oil and gas. I.R.C. § 613A(c)(4). Various other percentages are specified in I.R.C. § 613(b) for a wide variety of other minerals; for any mineral not specifically listed, the percentage depletion rate is fourteen percent (except for certain specified minerals for which percentage depletion is disallowed entirely, including soil, water, and minerals from inexhaustible sources, such as the air or sea water). However, the percentage depletion allowance is limited to fifty percent of the taxpayer's taxable income from the property computed without reference to either cost or percentage depletion. I.R.C. § 613(a); Treas. Reg. § 1.613-1.

Percentage depletion continues to be available after the basis of the mineral property has been reduced to zero, but in the case of coal (and iron ore), corporate taxpayers are required under I.R.C. § 291(a)(2) to reduce the percentage depletion deduction by twenty percent (of the gross income from the property) after the basis of the property has been reduced to zero. This rule applies after the fifty percent of taxable income ceiling on percentage depletion is applied. Thus, percentage depletion with respect to a leased coal deposit will, therefore, be eight percent for a corporation that is not subject to the 50 percent of taxable income ceiling, but if the ceiling applies, the effective percentage will be even lower.

For both solid minerals and oil and gas, I.R.C. § 57(a)(1) treats the excess of percentage depletion over the basis of the property at the end of the year (before subtracting the depletion allowance for that year) as a tax preference item in computing both the corporate alternative minimum tax and the individual alternative minimum tax under I.R.C. § 55. It should be noted that this treatment eliminates for minimum tax purposes the excessive cost recovery feature of percentage depletion, but it does not negate the acceleration of depletion that can be affected by percentage depletion. For C corporations (but not S corporations), however, this acceleration is partially negated by the inclusion in alternative minimum taxable income under I.R.C. § 56(c) and (f) of one half of the amount by which adjusted net book income of the corporation exceeds alternative minimum taxable income (before taking into account the book income preference).

In Rev. Rul. 76-533, 1976-2 C.B. 189, the I.R.S. ruled that percentage depletion is properly claimed as a deduction in the year the mineral, oil or gas is sold, not in the year it was produced. But when I.R.C. § 263A applies (to operators), percentage depletion is treated as an inventory cost in the year that the mineral is produced. Temp. Reg. § 1,263 A-1 T(b)(2)(iii)(K). Thus it appears that different rules with respect to the timing of the depletion allowance apply to operating interests and nonoperating interest. Income from the extraction and sale of natural resources as an operator should be computed on the accrual basis and not on the cash basis. *See* Treas. Reg. § 1.471-1; Treas. Reg. § 1.446-1(c)(2)(i). A nonoperator reports royalty income under his normal method of accounting.

Percentage depletion is not available in any year in which the taxpayer incurs a net operating loss with respect to the property.

(b) Special Rules For Oil and Gas: I.R.C. Section 613A

In addition to the general rules governing the computation of percentage depletion discussed above and in Part VII, infra, percentage depletion for oil and gas is subject to additional restrictions imposed by I.R.C. § 613A. Louisiana Land & Exploration Co. v. Commissioner, 90 T.C. No. 38 (1988) held that I.R.C.

§ 613A applies only to hydrocarbon fuels produced from oil and gas wells and not to other minerals extracted from wells in gaseous form. According, the taxpayer was permitted to deplete under § 613 sulphur produced from hydrogen sulfide extracted from "sour gas."

Percentage depletion for oil and gas is generally available only for independent producers and royalty owners. I.R.C. § 613A(c). This limitation is effected by denying percentage depletion under I.R.C. section 613A(c) to any large refiner, I.R.C. § 613A(d)(4) (defined with reference to a 50,000 barrel refinery run on any day during the taxable year), and any large retailer of oil or gas, I.R.C. § 613A(c)(2) (defined with reference to $5,000,000 of sales in the taxable year through owned or franchised retail outlets). *See* Prop. Reg. § 1.613A-4(b), 4(c). For the definition of a refiner, see Prop. Reg. § 1.613A-7(s). Note that a retail outlet includes any place where gross receipts from sales of oil, natural gas, or a product of oil or natural gas to end users are five percent or more of total gross receipts. Prop. Reg. § 1.613A-7(r). Bulk sales to industrial or commercial users, however, are not considered retail sales.

Whether a person is a refiner or retailer generally is determined with respect to the activities of both the taxpayer and any related person. I.R.C. § 613A(d)(3). A related person is an entity in which the taxpayer has an interest of five percent or more. See Prop. Reg. §613A-7(m). Note, however, that a producing subsidiary of a parent retailer (or a subsidiary of a parent that owns a retailer as another subsidiary) is not a retailer if none of the producing subsidiary's production is sold through the related retailer. Rev. Rul. 85-12, 1985-1 C.B. 181. *See generally Witco Chem. Corp. v. United States*, 742 F.2d 615 (Fed. Cir. 1984) (applying these provisions and finding that the taxpayer's retail sales were within the five million dollar safe harbor).

In addition, I.R.C. §§ 613A(b)(1)(A) and (3)(A) provide a limited exception to the strictures of I.R.C. § 613A for certain natural gas sold pursuant to a contract that was in effect on February 1, 1975 and at all times thereafter under which the price of the gas cannot be modified to reflect the increase in the seller's tax liability that would be caused by the repeal of percentage depletion.

Under the independent producer or royalty owner exception, percentage depletion may be computed only with reference to 1,000 barrels of average daily production. I.R.C. § 613A(c)(3). In computing the 1000 barrel per day limitation, production for which the independent producer exception does not apply, such as fixed contract natural gas or production from a transferred proven property, is not taken into account. I.R.C. § 613A(c)(9)(A). Once percentage depletion allowable on an average daily production of 1,000 barrels of oil has been computed, the allowable depletion is the greater of percentage depletion so computed or cost depletion on the total production. *See* Prop. Reg. § 1.613A-3(d)(4). (Example 1) for the method of computing allowable percentage depletion when average daily production exceeds 1,000 barrels. A taxpayer may elect to convert all or a portion of his depletable oil quantity to depletable natural gas at a conversion ratio of 6,000 cubic feet of gas per barrel of oil. I.R.C. § 613(c)(4).

Section 613A(d)(5), added by the Tax Reform Act of 1986, denies percentage depletion for lease bonuses, advance royalties, or other amounts payable without regard to production. This provision, which reverses the decision in *Commissioner v. Engle*, 464 U.S. 206 (1984), applies to amounts received or accrued after August 16, 1986 in taxable years ending after that date. However, cost depletion is still allowed for bonuses and advance royalties.

A taxpayer that has a partial interest in a well may compute percentage depletion only with reference to his proportionate share of the 1,000 barrels. I.R.C. § 613A(c)(2)(B). The proposed regulations treat the holder of a net profits interest as owning the same fraction of production from the property as his share of net profits; (for example, a ten percent net profits interest is treated as an interest in 1/10 of gross production). Prop. Reg. § 1.613A-7(f)(3). This treatment is obviously inconsistent with the fundamental theory of net profits interests.

Section 613A(c)(8) requires that the 1,000 barrel per day allowance be apportioned among related corporations, trusts or estates (using a fifty percent common control test) and members of a family (including only spouses and minor children); and it treats all members of a controlled group of corporations as one taxpayer. *See* Prop. Reg. § 1.613(A)-3(g). The 1000 barrel per day limit is allocated among the related parties relative to each taxpayer's production. In addition, percentage depletion of oil and gas must be computed by individual partners and not by the partnership. I.R.C. § 613A(c)(7)(D). The same rule applies to S Corporations. I.R.C. § 613A(c)(13).

Any taxpayer who is eligible to claim percentage depletion under the above threshold limitations, must also satisfy several other restrictions on availability and amount of percentage depletion.

Percentage depletion is not available to any transferee of a *proven* property if the transfer occurred after 1974. I.R.C. § 613A(c)(9). A property is "proven" if the principal value of the property has been demonstrated by prospecting, exploration, or discovery work. This test is satisfied only if at the time of the transfer: (1) oil or gas has been produced from the deposit (but not necessarily from the property); (2) prospecting, exploration, or discovery indicate that it is probable that development of the property will be justified; and (3) the fair market value of the property at the time of the transfer is at least fifty percent of the fair market value of the property at the time production commences. *See* Prop. Reg. § 1.613A-7(p).

Treas. Reg. § 1.613A-7(n) defines the term "transfer" to include any change in the legal or equitable ownership of the property. Contribution to a partnership or a trust, however, is not a transfer to the extent that the taxpayer was entitled to percentage depletion prior to the contribution. See Prop. Reg. § 1.613A-7(o). For examples of transfers, see Prop. Reg. § 1.613A-3(h). Under Prop. Reg. § 1.613A-7(n)(8), unitization will not be treated as a transfer. Transfers by death are also ignored, as well as certain transfers that occur as a result of changes in trust beneficiaries. I.R.C. § 613A(c)(9)(B)(i), (B) (iii). Also excepted by I.R.C. § 613A(c)(9), but subject to the requirement that the transferor and the transferee apportion betweem them a single 1000 barrel per day limtation are the following: (1) I.R.C. § 351 contributions to corporations; (2) transfers between corporations that are members of the same control group; (3) transfers between businesses under common control; (4) transfers between members of the same family; and, (5) transfers between a trust and related persons in the same family.

In addition, I.R.C. § 613A(c)(10) allows corporations that have acquired a proven property from an individual in certain I.R.C. § 351 transactions to continue to claim percentage depletion. In such a case the transferor's 1000 barrel per day limit is reduced by the corporation's eligible production allocated to the transferred property *and* by the transferor's share of the corporation's 1000 barrel limit (or, if less, average daily production) attributed to other properties. This exception applies only if all shareholders of the corporation received their stock solely in consideration of the transfer of oil and gas properties that had not been previously transferred as proven properties. In addition, the corporation's 1000 barrel limit will be reduced proportionately as a result of post incorporation transfers of stock (except for transfers of stock to a spouse or minor child). *See generally* Prop. Reg. § 1.613A-3(h)(2), (Examples 1 and 2).

Percentage depletion of oil and gas may not exceed fifty percent of the taxable income from the property for the year. It is further limited to sixty-five percent of the taxpayer's overall taxable income for the year, without an allowance for percentage depletion, but taking into account cost depletion and after making certain other adjustments. I.R.C. § 613A(d)(1). See Prop. Reg. §§ 1.613A-4(a), -7(q). For this purpose taxable income does not take into account net operating loss carrybacks or, for corporations, capital loss carrybacks. Percentage depletion disallowed under this provision is, however, subject to an unlimited carryover.

If the sixty-five percent limit applies, the allowable percentage depletion is allocated among all properties eligible for percentage depletion in proportion to each property's depletion, and this is the amount by which the basis of the property is reduced. If the percentage depletion so allocated to any property is less than cost depletion with respect to that property, the excess of percentage depletion over cost depletion is reallocated to other properties with respect to which percentage depletion exceeds cost depletion. If any percentage depletion disallowed under the sixty-five percent limitatation is allowed in a subsequent year under the carryover rules, the basis of the property to which it is attributable must be reduced in the year of allowance. *See* Prop. Reg. § 1.613A-4(a).

C. *Recapture of Depletion Deductions*

For mineral properties placed in service after December 31, 1986, both cost and percentage depletion are subject to recapture as ordinary income under I.R.C. § 1254, as amended by the Tax Reform Act of 1986 upon the disposition of the property. As long as there is no preferential treatment for long term capital gains, however, this provision is of minimal importance. The mechanics of computing recaptured ordinary income under revised I.R.C. § 1254 are somewhat complex.

The amount subject to recapture is the lesser of the gain realized (or the excess of the fair market value of the property over the adjusted basis if the disposition is not a realization event) or the sum of the following items: (a) the deductions for depletion previously claimed with respect to the property under I.R.C. § 611, but only to the extent that the depletion deductions reduced the basis of the property; (b) solid mineral exploration expenses deducted under I.R.C. § 617 with respect to the property that were not included in the basis of the property; (c) solid mineral development expenses incurred with respect to the property that were deducted under I.R.C. § 616; and, (d) in the case of oil and gas properties, all IDC deducted with respect to the property under I.R.C. § 263(c). Thus the amount of depletion actually recaptured depends, in part, on the amount of exploration and development expenditures or IDC deducted with respect to the property.

In a tax system that generally taxes only realized gains, treating cost depletion as a deduction subject to recapture, if it has any theoretical justification, requires adopting the view that the depletion allowance is in the nature of an allowance for depreciation rather than in the nature of cost of goods sold. This is an erroneous view, and recapture of cost depletion (or percentage depletion to the extent that it does not exceed hypothetical cost depletion) is unwarranted. If recapture of depletion is warranted at all, the amount subject to recapture should be the amount by which cumulative depletion deductions exceed the amount which would have been allowed if only cost depletion were allowed. Such a rule would recapture only the benefits of percentage depletion, and would reduce the tax expenditure benefits of percentage depletion to a mere timing advantage in some instances. Instead, Congress chose to relieve percentage depletion deductions in excess of basis from any recapture at all. In the context of depreciation this is akin to recapture of economic depreciation, but not of incentive accelerated depreciation. Such a rule would be quickly attacked as nonsensical.

I.R.C. § 1254(b)(1) provides exceptions to recapture similar to the exceptions to I.R.C. § 1245 recapture in I.R.C. § 1245(b). *See* Prop. Reg. § 1.1254-2, (proposed under a prior version of I.R.C. § 1254, but still relevant). Thus, there is no recapture upon gifts, transfers at death, contributions to a corporation or partnership, distributions by a partnership, or like kind exchanges.

If the taxpayer disposes of only a portion of a property, (other than an undivided interest) the entire amount of depletion is allocated to the portion disposed of, but if not all depletion is recaptured upon the disposition, the balance is reallocated to the remaining property. I.R.C. § 1254(a)(2); Prop. Reg. § 1.1254-1(b).

If the taxpayer disposes of an undivided interest in the property, a proportionate part of the depletion is allocated to the portion disposed of. I.R.C. § 1254-1(b)(2). If the taxpayer can satisfy the Commissioner that the depletion deductions do not relate to the portion of the property disposed of, a lesser portion of the depletion deductions will be allocated to the portion of the property disposed of, and recapture accordingly will be reduced. Examples of the application of this rule are provided in the proposed regulations.

If a mineral property subject to I.R.C. § 1254 recapture is disposed of in an installment sale, the portion of each payment that represents gain is treated as I.R.C. § 1254 recapture income until all of the recapture income has been reported. Prop. Reg. § 1.1254-2(d). I.R.C. § 453(i) does *not* apply to I.R.C. § 1254 recapture income.

II. ENTITLEMENT TO THE DEPLETION ALLOWANCE: THE CONCEPT OF ECONOMIC INTEREST

A. Definition of Economic Interest

Only a taxpayer with an economic interest in the mineral property may claim a depletion allowance. The concept of economic interest finds its roots in the Supreme Court's decision in *Palmer v. Bender*, 287 U.S. 551 (1933), and has been developed almost exclusively through case law. I.R.C. § 1.611-1(b)(1) provides a broad definition of an economic interest, based largely on the formulation in *Palmer v. Bender*. The regulations define the term "economic interest" as follows:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . ., to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit . . . does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction . . . does not convey a depletable economic interest.

This standard does not require that the taxpayer "own" the mineral deposit in order to claim the depletion allowance. Any number of types of relationships to the deposit may constitute an economic interest, but many other relationships will not constitute an economic interest.

Although it cannot be readily discerned from the definition in the regulations, examination of the cases reveals that an actual investment in cash or equivalent value is not in fact a prerequisite of an economic interest. To meet the first half of the test, the taxpayer merely need acquire an interest in the minerals in place. *See Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1951). Nevertheless, courts, particularly the Tax Court, frequently set out on a misguided search for a direct investment or a "significant related investment" that is a "practical prerequisite to successful exploitation of rights to mine the minerals in place." *Weaver v. Commissioner*, 72 T.C. 594, 602 (1979). The definition of economic interest has, in fact, developed largely on a case by case basis, and a detailed examination of the relevant cases is necessary to instill the definition in the regulations with any significant meaning.

From the advent of the economic interest concept up to 1981, the most obvious common thread in the cases holding that a taxpayer, other than a taxpayer who purchased an interest in the mineral deposit, had an economic interest in minerals in place was that the taxpayer either controlled the right to extraction or had at some time held title to or the right to control extraction of the minerals and had conveyed away that right or title in a transaction in which the taxpayer had retained a right to payment upon extraction. The recent decision of the Supreme Court in *United States v. Swank*, 451 U.S. 571 (1981), eschewed reliance upon the technical definition theretofore applied to determine whether a taxpayer held an economic interest in favor of an analysis based primarily on whether the taxpayer enjoyed a share of the sales proceeds from the extracted mineral. In that case the Court decided that a lessee under a lease terminable by the lessor without cause on thirty days prior notice held an economic interest in the deposit. Although the Court did not purport to be breaking new ground in *Swank*, its decision renders the definition of economic interest incoherent.

The most recent significant restatement of the theoretical test for an economic interest is in *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115 (1986). In that case the court stated that "the test under section 1.611-1(b)(1), Income Tax Regs., requires first that there be an investment, which requires that the payments must be in exchange for the receipt of minerals and that there must also be an investment in the production." The court then went on to state that:

> The 'investment' test requires only an economic commitment to look to production of the mineral for income. . . . There must be a clear capital interest in the mineral which diminishes as the mineral is extracted, and the taxpayer must share directly in the economic productivity of the minerals and the market risk upon sale of the minerals.

Applying this test, the court held that Gulf had an economic interest in certain oil deposits owned by Iran and operated by an Iranian corporation, because Gulf was a member of a consortium that provided funds for exploration, development, and operation in consideration of the right to purchase production at the wellhead and the right to determine the amount of production. While the result in *Gulf Oil* appears to be correct under either the test as stated in the regulations or as restated and embellished by the Tax Court, the restated test is internally contradictory, difficult to understand and apply, and appears in some instances to produce results contrary to long established rules.

For a thorough discussion of the early development of the economic interest concept *see* Snead, The Economic Interest — An Expanding Concept, 35 Tex. L. Rev. 307 (1957).

B. Relationships to a Mineral Deposit That Constitute an Economic Interest

In addition to the fee owner of a mineral deposit, numerous other interests may constitute an economic interest, entitling the owner of the interest to claim a depletion allowance with respect to income from the mineral property.

1. Royalty Holders

(a) Lessors

(1) Generally

The lessor of a mineral property has an economic interest. *See Burnett v. Harmel*, 287 U.S. 103 (1932). The royalty may be a fractional royalty, *Id.*, a net profits royalty, *see Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), or a fixed sum per unit of mineral extracted, *see Bankers Pocohantas Coal Co. v. Burnet*, 287 U.S. 308 (1932). Generally, lessors claim depletion deductions not only on royalties, but also with respect to bonuses and royalties received. *See Murphy Oil Co. v. Burnett*, 287 U.S. 299 (1932). In *Commissioner v. Engle*, 464 U.S. 206 (1984), the Supreme Court held that oil lessors could claim percentage depletion on bonuses and advance royalties received subject to I.R.C. § 613A. Congress subsequently enacted I.R.C. § 613A(d)(5) prospectively reversing this decision. *See* Part IX.B. *infra*, (containing detailed information on the treatment of lessors of oil and gas).

(2) Coal and Domestic Iron Ore Lessors

For tax years prior to 1987, the lessor of a coal or domestic iron ore deposit, instead of deducting a depletion allowance, was entitled to the more advantageous treatment of I.R.C. § 631(c), which treats royalties as an amount realized on the sale of an I.R.C. § 1231 asset, resulting in capital gains treatment. With the repeal in the Tax Reform Act of 1986 of preferential treatment of capital gains formerly accorded by I.R.C. §§ 1201 and 1202, coal and iron ore lessors will be entitled to claim percentage depletion for any year in which the rate of tax on long term capital gains is the same as the rate on ordinary income. *See* H.R. Rep. No. 841, 99th Cong., 2d Sess., II-126-27. *See* Part IX.C., *infra*, (for detailed information on coal lessors).

(b) Overriding Royalties

Several other types of royalty holders may have an economic interest in the deposit and be entitled to depletion on royalties received with respect to either solid mineral or oil and gas properties. These royalties may be fractional, net profits, or fixed sum per unit royalties. However, these royalty holders have not "disposed of" an interest in the deposit and are, therefore, not eligible for I.R.C. § 631(c) treatment if the royalties are received with respect to a coal property.

The holder of a royalty granted to the owner of surface rights in consideration of granting the owner of the mineral deposit (including a lessee) access to the deposit has an economic interest. *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1951). *See Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); Priv. Ltr. Rul. 7945006.

The holder of a royalty granted as a finder's fee or for negotiating a mineral lease has an economic interest and royalties attributable to the mineral property are depletable. In one case, the Tax Court held that royalties payable with respect to a mineral property granted in consideration of services in acquiring a different mineral property are not depletable; the holder of the royalty had no economic interest in the other properties. *Cline v. Commissioner*, 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980); Rev. Rul. 77-84, 1977-1 C.B. 173. This holding is incorrect. A nonoperating interest received in exchange for any consideration (or as a gift for that matter) constitutes an economic interest. *See* Rev. Rul. 83-46, 1983-1 C.B. 16 (ruling that receipt of royalty interest is an economic interest that is taxable under I.R.C. § 83(a) at time royalty interest is created).

Rev. Rul. 73-80, 1973-1 C.B. 308, held that the grantor of an option to purchase a mineral property who received a royalty interest to be paid upon commencement of operations could deplete the royalty received for the option.

The I.R.S. treats carved out aggregate net profits royalties as an economic interest in a single property. *See* Gen. Couns. Mem. 38,907 (Oct. 14, 1982); Priv. Ltr. Rul. 8543030.

2. Lessees

A lessee clearly holds an economic interest in the leased mineral deposit. I.R.C. § 611(b)(1). *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925). For many years the Internal Revenue Service argued that lessees operating under a lease terminable on short notice, without cause, did not hold an economic interest. This issue was resolved in *United States v. Swank*, 451 U.S. 571 (1981), in which the Supreme Court held that a lessee operating under a lease terminable without cause on thirty days prior notice held an economic interest.

In Rev. Rul. 83-160, 1983-2 C.B. 99, the Internal Revenue Service revised its position on the effect of terminability after *Swank*, stating that the terminability of a mineral lease at the will of the lessor "is not an essential criterion that, *by itself*, will preclude a taxpayer from having an economic interest." (emphasis added). Accordingly, the I.R.S. revoked a series of previous rulings that had denied an economic interest to taxpayers operating under leases terminable on short notice, Rev. Rul. 74-506, 1974-2 C.B. 178; Rev. Rul. 74-507, 1974-2 C.B. 179; Rev. Rul. 77-341, 1977-2 C.B. 204; Rev. Rul. 77-481, 1977-2 C.B. 205. This leaves open the possibility that the I.R.S. will consider terminability as a *factor*, among others, in evaluating whether a particular relationship to a mineral deposit constitutes an economic interest.

One of the revoked rulings is particularly worth noting. Rev. Rul. 77-341 had held that a lessee of a coal deposit in Kentucky under an oral lease did not have an economic interest because under the Kentucky statute of frauds his lease was unenforceable. Although the ruling was revoked, this does not necessarily mean that the I.R.S. now views a lessee under an oral (or otherwise unenforceable) lease as having an economic interest. The I.R.S. continues to argue that a licensee has no economic interest. *See* Part II.B.4., *infra*. The rights of a lessee under an unenforceable lease are generally considered to be those of a licensee. *See* 3 American Law of Mining, 269-70 (1982).

3. Contract Miners

(a) Fixed Fee Miners

Under the Supreme Court decisions in *Parsons v. Smith*, 359 U.S. 215 (1959) and *Paragon Jewel Coal Company v. Commissioner*, 380 U.S. 624 (1964), contract miners who received a fixed fee per ton (or other unit) of mineral extracted on behalf of the lessee or fee owner did not have an economic interest in the mineral deposit. In *Parsons v. Smith* the Court rejected the contract miners' argument that they had made a capital investment in the mineral in place giving rise to an economic interest through their contracts to mine the coal and their contribution of the use of their equipment and skills. The Court cited seven factors that distinguished the "economic advantage" possessed by the contract miners from an economic interest:

> To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable — not in the coal in place; (2) that their investments in equipment were recoverable through depreciation — not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was . . . agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place].

Five years later, in *Paragon Jewel Coal Co.*, the Court made clear that the most important of the above seven factors is the sixth factor — that the contract miner's fee was not directly related to the market price of coal and the owner was free to sell at any price and retain the entire proceeds in excess of the agreed upon fee. Furthermore, the Court stated that the terminability or nonterminability of the contract was not relevant. Nevertheless, terminability of contract mining agreements on short notice continues to be cited as a relevant factor, and the I.R.S. continues to believe that it is relevant in contract miner cases, *Swank* nowithstanding.

Adjusting the fixed price periodically to reflect labor and other costs or general trends in the market does not affect the result in contract mining cases. *See Paragon Jewel*, 380 U.S. at 624, (fixed contract price varied "depending somewhat on the general trend of the market price for the coal over extended periods and to some extent on labor costs"); *Constantino v. Commissioner*, 445 F.2d 405 (3d Cir. 1971) (contract miner frequently was paid more per ton than contract price); *McCall v. Commissioner*, 312 F.2d 699 (4th Cir. 1963) (fixed contract price subject to change as market price fluctuated); *United States v. Stallard*, 273 F.2d 847 (4th Cir. 1959) (same); *Adkins v. Commissioner*, 51 T.C. 957 (1969) (The contract price is to be adjusted in comparable ratio to substantial change in general price level); *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959) (A fixed contract price is subject to change if market price of lawful maximum price increased.); *see generally* McMahon, *Defining the "Economic Interest" in Minerals After United States v. Swank*, 70 Ky. L.J. 23, 44-52, 72-80 (1982).

(b) Percentage of Sales Miners

A contract miner who has a right to a fixed percentage of the net proceeds of the sale of extracted coal may have an economic interest even if the contract miner never has title to the coal or the right to sell it for his own account. Two cases that predated both *Parsons* and *Paragon Jewel Coal Company* held that contract miners who were entitled to a fixed percentage of net profits realized by the lessor upon sale of the coal had an economic interest in the coal and were entitled to the depletion allowance. *Ruston v. Commissioner*, 19 T.C. 284 (1952); *Brown v. Commissioner*, 22 T.C. 58 (1954). In both of these cases, however, the contract miner had the exclusive right to mine the deposits on behalf of the lessee and the agreement was not terminable without cause.

Following *Parsons v. Smith*, the Tax Court in *Utah Alloy Ores v. Commissioner*, 33 T.C. 917 (1960), held that a percentage of sales contract miner did not have an economic interest. More recently, however, in Rev. Rul. 84-88, 1984-1 C.B. 141, the I.R.S. reaffirmed that a percentage of sales contract miner may have an economic interest. It must be noted, however, that this ruling not only emphasized that the contract miner had the *exclusive* right to extract the mineral for sale by the owner (lessee), but, in contrast to Rev. Rul. 83-160, also specifically stated that he had the right to mine the deposit to exhaustion. A percentage of sales contract miner with a contract term of one year or more, however, would probably be found to have an economic interest. The one-year test was applied by the I.R.S. prior to *Parsons v. Smith* for determining whether a fixed fee contract miner held an economic interest. *See* Gen. Couns. Mem. 26,290, 1950-1 C.B. 42, 45-46.

(c) Distinguishing Contract Miners From Lessees

It is sometimes difficult to distinguish between a contract miner and a lessee when a lessee concurrently agrees to sell the output to the lessor or to meet the lessor's requirements for coal supplies. Establishing the exact nature of the relationship turns on all of the facts and circumstances.

In *Adkins v. Commissioner*, 51 T.C. 957 (1969) the taxpayer leased coal under one-year renewable leases (from a sublessor) that provided that no royalties were due on coal sold to the lessor. At the same time the lessee and lessor executed an output contract under which the lessee agreed to sell all of the extracted coal to the corporate parent of the lessor at a fixed price per ton, subject to certain adjustments if there was a significant change in the market price of coal. Either party could terminate the contract if he failed to agree on the price. The lessor paid all real estate taxes, royalties, and mine engineering costs. The Tax Court found that the facts were not substantially different from those in *Paragon Jewel Coal Co.*, and held that the taxpayer was a contract miner. The court's finding that the "lessor" treated the arrangement as a contract mining agreement and not as a true lease was significant.

A similar result was reached in *Bolling v. Commissioner*, 37 T.C. 754 (1962) in which the essential facts were similar except that the lessor had an option to purchase the mine output and the lease was terminable on thirty days notice. The purchase by the lessee of the surface rights was not considered to be sufficient to give him an economic interest under the principles of *Southwest Exploration Co.*

Thornberry Construction Co., Inc. v. United States, 576 F.2d 346 (Ct. Cl. 1978), reached the opposite conclusion on slightly different facts. The lessor, which was in the business of operating coal properties, leased a property that it did not want to operate to the taxpayer on the condition that the taxpayer execute requirements contracts with valued customers of the lessor. The customers, however, were unrelated to the lessor, and the lessee independently negotiated the sales contracts with the customers. The lease called for fixed royalties, but was terminable if the output was not sold to the designated customers. The lessee bore all development and operating costs, including the acquisition of certain surface rights. Because the lessee had sold the coal to a third party at a price negotiated at arm's length, the arrangement was held to be a true lease and not a contract mining agreement.

Rev. Rul. 72-477, 1972-2 C.B. 310 held that a lessee acquired an economic interest in the deposit on facts that much more nearly resemble those in *Adkins* and *Bolling* than those in *Thornberry Construction Co.* A mining company leased a coal deposit from a utility company for a term of twenty-one years, subject to the lessee's right to extend the lease for ten years if the coal was not worked out at the end of the initial term. The lease required royalties at a fixed amount (which was reasonable) subject to adjustment to reflect changes in the Wholesale Price Index. Under a contemporaneous coal sales agreement, the lessee agreed to sell and the utility agreed to purchase a specified amount of coal annually, but the utility company retained the right to increase the amount. The mining company was free to sell any coal that was extracted in excess of the amount required under the sales contract. The price to be paid for the coal was to be determined pursuant to a formula based on the mining company's costs plus a profit factor, subject to adjustment to reflect changes in the Wholesale Price Index. The ruling states that the price was "substantially equivalent to the open market price of coal." The supply agreement, like the lease, was for a twenty-one year term, but could be extended by the utility company if the lease was extended. Nevertheless, the I.R.S. concluded that the agreements were not coterminous because the supply agreement could terminate prior to termination of the lease.

Rev. Rul 73-32, 1973-1 C.B. 301 further confuses the criteria for distinguishing leases from contract mining agreements. A power company leased a coal deposit to a joint venture consisting of a subsidiary of the power company and an independent mining company. The lease was for sixteen years and required a royalty, but the parties simultaneously executed a requirements contract under which the lessee dedicated the reserves to supply the power company/lessor's needs. Extracted coal was processed in facilities owned by the power company. The lessee was permitted to sell on the market a limited amount of coal extracted in excess of the power company's needs. The power company subsidiary provided all of the equipment, the mining company provided the management, and each joint venturer provided one half of the working capital. Out of the joint venture's receipts, the power company subsidiary received a fixed fee per ton for the use of its equipment and the mining company received a fixed fee per ton for its management. Any remaining profits were divided equally.

The I.R.S. held that the joint venture had acquired an economic interest in the coal deposit because the lease was not terminable on short notice and the joint venture looked "for its compensation solely to the extraction and sale of coal." Nevertheless, careful analysis indicates that the facts of this ruling also more nearly resemble those in *Adkins* and *Bolling* than the facts in *Thornberry Construction Co. See generally* McMahon, *The Coal Depletion Allowance Deduction*, 85 W. Va. L. Rev. 58, 599-603 (1983).

Rev. Rul. 86-81, 1986-1 C.B. 249 held that a lessee which was obligated to sell its entire output to the lessor held an economic interest where the sale of the extracted coal was to be at market price and where the lessee had the right to mine to exhaustion. The lessor, who purchased the coal unprocessed and applied processes that would be mining processes if applied by the taxpayer that mined the coal, was found to have retained no economic interest other than the right to royalties. Thus, income from the sale of purchased and processed coal was not gross income from mining.

4. Licensees

Absent unique facts, licensees are generally held not to have acquired an economic interest in a mineral deposit. *See, e.g., Missouri River Sand Co. v. Commissioner*, 83 T.C. 193 (1984), *aff'd* 774 F.2d 334 (8th Cir. 1985); *Missouri Pacific Corp. v. United States*, 54 A.F.T.R.2d (P-H) 5157 (Ct. Cl. 1984); *Holbrook v. Commissioner*, 65 T.C. 415 (1947).

In *Holbrook* the Tax Court held that the taxpayer, who had a nonexclusive, nontransferrable license to extract coal, subject to termination on ten days notice, was not entitled to claim percentage depletion. That the licensee was free to sell the coal on his own behalf, acquiring title on extraction, had expended time and money in developing the underground mine, and operated under the license for four years, were all considered insufficient to confer an economic interest. A similar result was reached in *Rissler & McMurry Co. v. United States*, 480 F.2d 684 (10th Cir. 1973), *aff'g* 342 F. Supp. 432 (D. Wyo. 1972). The requirement of exclusivity conflicts with the substance of Rev. Rul. 70-499, 1970-2 C.B. 132. That ruling held that lessees under a "joint and several" lease held an economic interest even though they operated separately and enjoyed no exclusive rights among themselves. In contrast, licensees that did not have an exclusive legal right to extract minerals, but effectively had the sole ability to exploit a license, have been found to have an economic interest. *See Weaver v. Commissioner*, 72 T.C. 594 (1979); *Victory Sand & Gravel Co. v. Commissioner*, 61 T.C. 407 (1974); *Oil City Sand & Gravel Co. v. Commissioner*, 39 T.C. 31 (1959).

See generally, McMahon, *Licensees and Economic Interest in Minerals After Swank and Revenue Ruling 83-160*, 72 Ky. L.J. 787 (1984).

5. Joint Ventures

Rev. Rul. 74-469, 1974-2 C.B. 178 held that both X Corp. and Y Corp. had an economic interest in the deposit that they operated under the following joint venture arrangement. X Corp., which held certain mineral leases, granted to Y Corp. the right to mine the leased deposits to exhaustion. Y obtained all permits in X's name. X Corp. paid all royalties and conducted all extraction activity, processing, and storage. Under the agreement, however, title to the minerals was vested in X Corp. and Y Corp. in specified shares, and each sold its share separately through an independent agent. Whether X Corp. had an operating interest or a royalty payable in kind is not clear from the ruling.

Rev. Rul. 77-1, 1977-1 C.B. 161 held that a partnership or corporation operating a "captive mine" holds the economic interest and is the proper taxpayer to claim the depletion allowance. Of course, if the operator of the captive mine is a partnership or joint venture, the depletion allowance will pass through to the partners under I.R.C. §§ 701-704.

6. Production Payments

(a) Treatment

Under *Thomas v. Perkins*, 301 U.S. 655 (1937), the holder of a production payment holds an economic interest in the mineral deposit and realizes ordinary income subject to depletion upon receipt of payments. This basic rule, however, is largely supplanted by I.R.C. § 636, enacted in 1969, which breaks production payments down into four categories.

(1) Carved Out Production Payments

I.R.C. § 636(a) treats a carved out production payment as a mortgage loan from the buyer to the seller, unless the proceeds of the production payment are pledged for exploration or development of the property. *See* Treas. Reg. § 1.636-1(a). Thus, the payee realizes ordinary income only to the extent of the interest, the computation of which is subject to the original issue discount rules of I.R.C. §§ 1272-1275 or I.R.C. § 483, and may not claim depletion. The payor includes the full payment in gross income but deducts the interest element. *See* Treas. Reg. § 1.636-1(a)(1) and (3) Treas. Reg. § 1.636-1(a)(3) (Ex. 1).

A carved out production payment pledged to exploration or development constitutes an economic interest held by the payee, who realizes ordinary income subject to depletion. Treas. Reg. §

1.636-1(b). Cost depletion will almost invariably be claimed. Rev. Rul. 65-10, 1965-1 C.B. 254 allows the holder of a production payment to elect between two alternative methods of computing the depletion unit for cost depletion. The payor excludes the production payment from gross income, and may not deduct expenses funded by the proceeds from the sale of the payment. *See id.*; *Anderson v. Commissioner*, 466 F.2d 672 (5th Cir. 1971). Carved out production payments that finance operations, however, are treated as mortgage loans. Treas. Reg. § 1.636-1(b); Rev. Rul. 74-549, 1974-2 C.B. 186 (carved out production payment to finance removal of overburden where overburden removal benefitted only minerals directly underlying removed overburden). *Compare with* Rev. Rul. 86-83, 1986-1 C.B. 251 (removal of overburden making minerals accessible over long period of time was development cost).

(2) Retained Production Payment on Sale

Section 636(b) treats a production payment retained upon sale (when the transferor retains no economic interest other than the production payment) of a mineral property as a purchase money mortgage loan; the payee has no economic interest.

(3) Retained Production Payment on Lease

Section 636(c) treats a production payment retained in a lease as a bonus payable in installments. The lessor may claim depletion in the case of oil and gas or I.R.C. § 631(c) treatment in the case of coal. The lessee must capitalize the payments into depletable basis. Treas. Reg. § 1.612-3(a)(3). Nevertheless the lessee must exclude the payment from gross income from the property under I.R.C. § 613 in computing percentage depletion for the year of extraction of the minerals to which the bonus payments relate. Treas. Reg. § 1.613-2(c)(5)(ii); Rev. Rul. 79-73, 1979-1 C.B. 218.

(b) Definition

"Production payment" is defined in Treas. Reg. § 1.636-3(a). In capsule form a production payment is an economic interest in the form of a right to a share of the minerals or proceeds from the sale of the minerals produced from a property, having an expected economic life shorter than that of the burdened property. Production payments are frequently in the form of a royalty that is extinguished after a specific amount has been paid. Where there is no reasonable prospect that a purported production payment will be paid off during the economic life of the burdened mineral deposit, the interest will be reclassified as a royalty. *Watnick v. Commissioner*, 90 T.C. No. 26 (1988). *See also*, *United States v. Morgan*, 321 F.2d 781 (5th Cir. 1963).

Rev. Rul. 86-119, 1986-2 C.B. 81 held that if an investor advances money to an oil and gas operator in consideration of the right to receive from production the lesser of twice the amount advanced or a specified percentage of the net proceeds from the sale of produced hydrocarbons, and the only indication that hydrocarbons will be produced from the property is favorable geological and geophysical reports, the interest obtained will be a royalty and not a production payment. *Compare United States v. Foster*, 324 F.2d 702 (5th Cir. 1963), in which the court found that an interest in a nonproducing property could be a production payment. Production from an adjacent tract indicated that the expected life of the payment was less than the expected producing life of the property.

The I.R.S. treats a blanket production payment covering multiple properties (as defined in Gen. Couns. Mem. 22,736), 1941-1 C.B. 214, rather than I.R.C. § 614) as an economic interest in a single property if the interest otherwise qualifies under I.R.C. § 636(a). *See* Gen. Couns. Mem. 32,478. But if two or more production payments, the proceeds of which are pledged to development, thereby otherwise qualifying under I.R.C. § 636(a) are "cross guaranteed," the production payment will not be treated as an economic interest. *Lehigh Portland Cement Co. v. United States*, 433 F. Supp. 639 (E.D. Pa. 1977), *aff'd by unpublished order* (3d Cir. 1977).

Freede v. Commissioner, 86 T.C. 340 (1986) held that advance payments by a gas pipeline company to the owner of a working interest in a gas property pursuant to a "take or pay" contract were nontaxable mortgage loan proceeds under I.R.C. § 636(a) when received by the payee on the theory that the payor, by virtue of the payments, acquired a production payment that would have otherwise constituted an interest in the minerals in place, satisfying the test of an economic interest. While this result can be reached by a literal interpretation of the language of I.R.C. § 636(a), it is a tortured application of the provision in light of its legislative history. *See Brountas v. Commissioner*, 692 F.2d 152 (1st Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983) (refusing to allow a tortured application of I.R.C. § 636(a) to circumvent the at-risk rules of I.R.C. § 465).

The IRS has ruled that excess payments under "take or pay" contracts do not give rise to a production payment. Instead, the I.R.S. treats such payments as ordinary income includable by the payee in the year of receipt. Rev. Rul. 80-48, 1980-1 C.B. 99.

III. THE MINERAL PROPERTY CONCEPT

A. Generally

Both cost and percentage depletion are computed with reference to an individual mineral "property." The identification of a mineral "property" is governed by I.R.C. § 614. Identification of separate mineral properties is crucial, however, not only in determining the proper computation of the depletion allowance, whether computed under the cost or percentage method, but also in allocating exploration expenses to basis for oil and gas properties, or for solid mineral properties pursuant to I.R.C. § 617(b)(1)(A) recapture, and for determining the proper year for claiming, and the amount of any loss on abandonment of a mineral property. All of these items are determined on a property by property basis.

The effect of intangible drilling and development costs under I.R.C. § 263(c) and solid mineral development expenses under I.R.C. § 616 on taxable income from the property are also dependent on the identification of the property to which they relate. For example, the cost of drilling what proves to be a dry well bottomed in a second oil horizon underlying an already producing horizon must be deducted in computing the fifty percent of taxable income from the property ceiling on percentage depletion (if the taxpayer is eligible for percentage depletion under I.R.C. § 613A(c)) unless the taxpayer has made a proper separate property election under I.R.C. § 614(b)(2). *See* Rev. Rul. 77-136, 1977-1 C.B. 167. Otherwise, all oil and gas operating interests within a single tract or parcel of land, even if they relate to different deposits, will be a single property under I.R.C. § 614(b)(1).

A similar effect arises — under different statutory provisions — in the case of solid mineral development expenses. Under I.R.C. § 616, solid mineral development expenses are deductible on a mine-by-mine basis. Thus, if the taxpayer has a mine in the production stage on one area of a mineral property and develops a new mine to exploit the same deposit on a separate site on the same mineral property, the development expenses of the second mine must be deducted in computing the fifty percent of taxable income from the property ceiling on percentage depletion. This detrimental effect, however, may be avoided by an election under I.R.C. § 614(c)(2) to treat each mine as a separate mineral property for all purposes. *See* Treas. Reg. § 1.614-3(a)(1).

Conversely, in many instances a taxpayer may have two or more separate mineral properties that it desires to treat as one property for all purposes. The general rule of I.R.C. § 614(a) leads to a multiplicity of solid mineral properties in many instances. For example, if a taxpayer operates a single mine to extract a single mineral deposit underlying three contiguous tracts or parcels of land acquired from different owners or from the same transferor at different times, there are three separate properties. To apportion exploration and development expenses, and particularly to compute gross income from mining and taxable income from mining separately for each property may be difficult, if not impossible. In such an instance the mine operator may avail itself of the election under I.R.C. § 614(c)(1) to aggregate two or more separate mineral interests that constitute "all or part of a single operating unit" and, thereafter, to treat the aggregate properties as a single property.

B. Definition of Property

1. Statutory Definition

I.R.C. § 614(a) defines the "property" as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." As far as oil and gas properties are concerned, however, the general rule is modified by I.R.C. § 614(b) which treats operating interests of a taxpayer in separate deposits underlying a single tract or parcel of land as a single mineral property. *See also*, Treas. Reg. § 1.611-1(d)(7) and Treas. Reg. § 1.614-1(a)(3). An "interest" is an "economic interest in a mineral deposit." *See* Treas. Reg. § 1.614-1(a)(2). If a taxpayer has both an operating interest and a nonoperating interest in a particular mineral deposit, whether solid minerals or oil and gas, they are treated as separate interests. *See* Treas. Reg. § 1.614-1(a)(5) (Ex. 2); *Lloyd Corp., Ltd. v. Riddell*, 347 F.2d 455 (9th Cir. 1965) (taxpayer who owned one-half interest in fee and entire interest in lease had two separate interests); *Helvering v. Jewel Mining Co.*, 126 F.2d 1011 (8th Cir. 1942), *rev'g* 43 B.T.A. 1123 (1941) (lessee operated coal mine on portion of tract and subleased another portion of tract); *see also* Treas. Reg. § 1.614-3(a)(1) (1978) (prohibiting the aggregation of an operating interest and 1.614-3(a)(1) (1978) (prohibiting the aggregation of an operating interest and a nonoperating interest).

2. Tract or Parcel of Land

A separate "tract or parcel of land" is identified by the manner of acquisition. The regulations provide as follows:

> All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) from separate owners are separate tracts or parcels of land even though the areas described may be contiguous.

Treas. Reg. § 1.614-1(a)(3).

The regulations provide numerous examples of the operation of these rules. Treas Reg. § 1.614-1(a)(5) (Ex. 1), (Ex. 9). Under the regulations neither the taxpayer's operating unit nor the fact that only one mineral deposit underlies several different tracts of land are significant in identifying the property, absent an election under I.R.C. § 614(c) to aggregate separate properties or fragment one property (either of which is available only for solid minerals). Thus, if the taxpayer conducts mining operations as a single operating unit on eight contiguous tracts overlying one coal deposit, but his interest in each tract was acquired from a different transferor, he is operating eight separate properties. Treas. Reg. § 1.614-1(a)(5) (Ex. 5), (Ex. 8) (For the definition of an "operating unit," *see* Treas. Reg. § 1.614-2(c).)

If the taxpayer acquired contiguous tracts overlying a single mineral deposit in one transaction, he has a single property even if his transferor had two separate properties because the transferor had acquired his interest in each tract from different transferors. *See* Rev. Rul. 68-566, 1968-2 C.B. 281, (separate simultaneous conveyances that are not interdependent do not give lessee one property). This rules applies, however, only if the transferor held the fee. The regulations distinguish between a lease from the fee owner, which can effect the unification of what were two separate properties for the lessor, and an assignment of the leases to two contiguous tracts leased from different fee owners. In the latter case, the tracts remain separate properties for the assignee of the leases. Treas. Reg. § 614-1(a)(5) (Ex. 9).

There is one important exception to the aggregation of properties effected by a transfer as described above. If the properties' bases in the hands of the transferee are determined by reference to their bases in the hands of the transferor, then the properties must be treated as separate properties by the transferee if they were so treated by the transferor. Treas. Reg. § 1.614-1(a)(4). This rule is of particular importance when the holder of separate, but contiguous, properties overlying a single deposit contributes them to a partnership in exchange for a partnership interest or to a corporation in a transaction in which no gain is recognized under I.R.C. § 351. In either case the properties remain separate properties in the hands of the partnership or corporation due to the transferred basis rules. I.R.C. § 723 (partnership); I.R.C. § 362 (corporations).

3. Mineral Deposit

Each separate deposit must be treated as a separate property, even if the deposits underlie a single tract or parcel of land. Treas. Reg. § 1.614-1(a)(3) (last sentence); § 1.614-1(a)(5) (1973) (Ex. 7). Thus, each separate coal seam underlying one surface tract is a separate property. A culm bank or waste deposit is not treated as a separate mineral deposit, however, but is part of the deposit from which it was extracted. Treas. Reg. § 1.614-1(c).

As noted above, pursuant to I.R.C. § 614(b), this separate deposit-separate property rule does not apply to different hydrocarbon deposits underlying a single tract. A coal deposit and an oil or gas deposit both underlying a single tract, however, are separate properties.

4. Unitization of Oil and Gas Wells

If oil or gas wells are either voluntarily or involuntarily unitized the general rules regarding identification of the property for operating interests are inapplicable, and all of the unitized wells will be treated as one property. I.R.C. § 614(b)(3); Treas. Reg. § 1.614-8(b). In the case of a voluntary unitization, however, this exception applies only if all of the operating interests subject to the plan are in the same deposit, or are in multiple deposits, the joint development and production of which is logical without taking tax benefits into account, and are in tracts of land which are contiguous or in close proximity. I.R.C. § 614(b)(3)(B); Treas. Reg. § 1.614-8(b)(2). These rules are applicable not only to the unitization of multiple operating interests owned by applicable not only to the unitization of multiple operating interests owned by two or more persons, but also to the unitization by one person of operating interests under several different leases. Treas. Reg. § 1.614-8(b)(6). This is the only exception to the general prohibition of voluntary aggregation of operating interests in oil and gas properties.

As a result of the pooling or unitization, the operators will be treated as having exchanged their interests in the separate properties for interests in the unit. *See* Rev. Rul. 68-186, 1968-1 C.B. 354; Treas. Reg. § 1.614-8(b)(6). The exchange, however, should be nontaxable under I.R.C. § 1031. However, if equalization payments are made to reimburse some operators for disproportionate development costs, the payments will be taxable "boot." Furthermore, equalization payments are not depletable, unless they are in the form of production payments.

Koziara v. Commissioner, 86 T.C. 999 (1986) held that an involuntary unitization is not an involuntary conversion under I.R.C. § 1231. The taxpayers sought such treatment for the purpose of treating the royalties received from the unitized property as capital gains. Because the property was not taken by eminent domain, the court rejected the taxpayers' argument. Accordingly, the royalties were taxed as ordinary income.

C. *Elective Aggregation of Solid Mineral Properties*

1. Generally

The tendency of I.R.C. § 614(a) to multiply the number of properties is offset by the provisions of I.R.C. § 614(c)(1) permitting the elective aggregation of operating interests in mines. I.R.C. § 614(c) does not apply to oil and gas properties. For the purposes of I.R.C. §§ 614(b) and (c) an "operating interest" is defined by I.R.C. § 614(d) as only an interest with respect to which production costs must be taken into account in computing the fifty percent of taxable income from the property limitation on percentage depletion. The definition is amplified in Treas. Reg. § 1.614-2(b). *See also* Treas. Reg. § 1.614-3(e) ("mine" defined).

(a) Aggregation Within Operating Unit

Aggregation is limited, however, to interests which constitute all or part of an "operating unit" of the taxpayer. Separate operating units are identified with reference to the taxpayer's own method of mining operations. Sharing common supply, maintenance, processing, treatment and storage facilities, and common field personnel are indicia that separate mineral interests or mines are part of a single operating unit. Geographically separated operating interests merely sharing a single set of accounting records, a single administrative organization, or a single sales or processing facility are not part of the same operating unit. *See* Treas. Reg. § 1.614-3(d); Treas. Reg. § 1.614-2(c)(1). *See also* Rev. Proc. 64-23, 1964-1 C.B. 689. As long as the operating unit requirement has been met, it is not necessary that the separate interests to be aggregated be included in a single parcel or tract of land or that they be contained in contiguous tracts or parcels of land. Treas. Reg. § 1.614-3(a)(1) (1978).

(b) Consistent Treatment Within Single Mine

If the taxpayer elects to aggregate properties, all properties comprising a single mine, including interests subsequently becoming part of the mine, must be aggregated. Treas. Reg. § 1.614-3(a)(1). *See also* Treas. Reg. § 1.614-3(a)(2) (aggregation in subsequent taxable years). If, however, two or more mines are contained within a single operating unit, the taxpayer may aggregate the interests comprising each mine separately or the taxpayer may elect to aggregate all mines within the unit as one property. Treas. Reg. § 1.614-3(a)(1). Under the regulations a "mine" is defined as "any excavation or other workings or series of related excavations or related workings. . . ." Treas. Reg. § 1.614-3(e). "Excavations" or "workings" include "quarries, pits, shafts, and wells (except oil and gas wells)." The particular facts and circumstances of the case determine the number of "excavations" or "workings" that constitute a single mine. Among the factors to be considered are the nature and position of the deposit or deposits; the method of mining; the location of the excavations or other workings in relation to the deposit or deposits; and the topography of the area. The taxpayer's determination of the composition of a mine is accepted unless there is clear and convincing evidence to the contrary. For an illustration of operating unit issues, *see* Rev. Rul. 74-215, 1974-1 C.B. 149, in which an operating unit consisted of eighteen separate tracts of land and thus eighteen interests. The taxpayer was permitted to separately aggregate the interests operated as an open pit mine and an underground mine. Among the reasons two different "mines" existed were differences in the ore quality and the different techniques, personnel and equipment which the operation of each mine required.

Conversely, a surface mine and a deep mine that are in fact treated as a single operating unit by the taxpayer may be aggregated as one property if the taxpayer so elects. *See Douglas Coal Co. v. United States*, 429 F. Supp. 322 (N.D. W.Va. 1977). The taxpayer has the freedom to choose whether two mines, each consisting of separate interests but included in one operating unit, will be aggregated as one property or two properties.

2. Effect on Basis

When two or more properties have been aggregated, the unadjusted basis of the aggregated property is the sum of the unadjusted bases of the separate interests that have been aggregated. The adjusted basis of the aggregated property is its unadjusted basis, adjusted for all prior adjustments to basis, including those required by prior depletion deductions claimed for each property. After aggregation, all adjustments to basis are computed on the adjusted basis of the aggregated property. Treas. Reg. § 614-6(a)(1).

If prior to the aggregation, percentage depletion in excess of basis had been claimed with respect to one of the properties, the previously claimed excess percentage depletion reduces the basis of the newly aggregated property derived from other previously separate properties, even though absent the aggregation, the basis of a property is not reduced below zero by percentage depletion in excess of basis. *See* Treas. Reg. § 1.614-b(a)(3) (Ex. 1); *see also* Rev. Rul. 75-451, 1975-2 C.B. 330 (prior percentage depletion in excess of basis offsets subsequent positive adjustments to basis for a single property).

3. Effect on Depletion

(a) Cost Depletion

Because the "depletion unit" for cost depletion is determined by dividing the adjusted basis of the mineral property at the end of the taxable year by what is essentially equivalent to the number of units of mineral remaining to be recovered at the beginning of the year, aggregation can significantly affect the cost depletion deduction available in any given year. *See, e.g., Day Mines, Inc. v. Commissioner*, 42 T.C. 337 (1964). If only cost depletion is claimed, however, this is merely a timing difference. Total depletion over the lives of the aggregated properties will always be equal to the sum of the adjusted bases of the separate properties regardless of whether they are aggregated. *But see* Rev. Rul. 75-451, 1975-2 C.B. 330.

(b) Percentage Depletion

When percentage depletion is claimed (either alone or intermixed with cost depletion), aggregation of properties can affect the total amount of depletion deductions claimed over the life of the deposit or deposits to be extracted. This result arises primarily from the effect of aggregation on the computation of the fifty percent limitation. But it may also occur if a property on which cost depletion would exceed percentage depletion is aggregated with one or more other properties, and percentage depletion is claimed on the aggregate property. It is impossible to determine definitely, in advance, whether aggregation will increase or reduce the aggregate amount of percentage depletion allowable. The result depends on the relative gross and taxable incomes from each of the properties. Aggregating a more profitable property with less profitable properties may increase the depletion deduction. However, aggregation of a property that is operating at a loss or at a *very low profit margin* and thus claiming cost depletion, with other properties that have not been subject to the fifty percent limitation, may result in a reduction of the taxable income from the aggregated property to the point where the fifty percent limitation limits the depletion allowance for the aggregated property to less than the allowable depletion computed for the properties separately.

D. Election to Separate A Single Mine Property

1. Generally

If the owner of an operating interest is or will be extracting the deposit in a single property by operating two or more mines, the taxpayer may elect under I.R.C. § 614(c)(2) to have each mine treated as a separate property. For the election to be made the taxpayer must have made expenditures for development or operation of each of two mines. *See* Treas. Reg. § 1.614-3(b)(1). The regulations provide that if there is more than one mineral deposit in a particular tract or parcel of land, an election under I.R.C. § 614(c)(2) regarding one deposit has no application to the other deposit. This is because the existence of two deposits gives rise to two properties despite their convergence in one tract or parcel of land.

2. Effect of Election

Following the election, depletion deductions will be separately computed for each mine. Thus, the taxpayer may elect to separate a mine in the development stage from an already operating mine to avoid a reduction in the fifty percent limitation that would be caused by the deduction of development expenses. However, if the mine is part of a property previously aggregated under I.R.C. § 614(c)(1), an election to treat the mine as a separate property may be made only with the consent of the Commissioner; and such consent will not be granted where the purpose of the election is based on the tax consequences. Treas. Reg. § 1.614-3(b)(1) (1978).

(a) Basis

If an election to separate mines in a single property is made, all of the deposit and tract or parcel of land to which it relates must be allocated among the separate properties created by the election. Treas. Reg. § 1.614-3(b)(2). The adjusted basis of the property with respect to which the election was made must be apportioned among the properties created by the election proportionate to the relative fair market values of the separate properties created by the election. Treas. Reg. § 1.614-3(b)(3).

(b) Subsequent Aggregation

Since a property is treated as a separate property for all purposes once it has been validly separated under I.R.C. § 614(c)(2), the taxpayer may subsequently aggregate the mine with other separate properties in the same operating unit, or, if the facts warrant, because the mine itself has developed into two or more separate mines, the taxpayer may elect under I.R.C. § 614(c)(2) to separate the property again, into two properties, each with a separate mine or mines. Treas. Reg. § 1.614-3(b)(1).

3. Procedures

Treasury Regulation § 1.614-3(f) provides detailed rules regarding the manner of making elections under I.R.C. § 614(c) and rules for resolving problems when the taxpayer makes an aggregation that is invalid under the substantive rules. *See* Rev. Rul. 74-480, 1974-1 C.B. 184, in which the I.R.S. held that an election under I.R.C. § 614(c) was valid where the taxpayer identified the properties by providing detailed maps instead of separate written descriptions of the properties as required by the regulations. The taxpayer must expressly indicate that an election is being made. *Estate of Bryan v. Commissioner*, 32 T.C.M. (P-H) ¶ 63,182 (1963).

E. Aggregation of Nonoperating Interests

The rules governing the aggregation of nonoperating interests under I.R.C. § 614(e) are provided in Treas. Reg. §§ 1.614-5(d) and (e). This election is available for nonoperating interests relating to both solid mineral and oil and gas properties. A nonoperating interest may not be aggregated with an operating interest, however. *Sence v. United States*, 394 F.2d 842 (Ct. Cl. 1968); *Lloyd Corp. v. Riddell*, 347 F.2d 455 (9th Cir. 1965).

Aggregation of nonoperating interests is subject to significantly different standards than aggregation of operating interests. First, the consent of the Commissioner is required. Consent will be given only if the taxpayer established that "a principal purpose [in forming the aggregation] is not the avoidance of tax." Treas. Reg. § 1.614-5(d). The regulations specifically state that the fact that the aggregation will result in a substantial reduction of tax is *evidence* that avoidance of tax is a principal purpose of the taxpayer. *See Miller v. United States*, 24 A.F.T.R. 2d (P-H) 5363 (E.D. Okla. 1969) (upholding the aggregation of nonoperating interests); *see also* Priv. Ltr. Rul. 8603080 (allowing aggregation of certain net profits interests in separate oil and gas properties producing from the same reservoir by a taxpayer who was not eligible to claim percentage depletion); Priv. Ltr. Rul 8614013 (allowing aggregation of royalty interests in solid mineral properties).

Unlike aggregation of operating interests, aggregation of operating interests is available only for adjacent tracts or parcels of land. To be "adjacent," two tracts or parcels of land need not have any common boundaries, but must be within "reasonably close proximity" to one another, taking into account all of the facts and circumstances.

An election to aggregate nonoperating mineral interests can have a significant effect when the lessor aggregates two nonoperating interests with respect to which a bonus was received and the lessee subsequently abandons one of the leases without production. The aggregation will preclude recapture under Treas. Reg. § 1.612-3(a) of the bonus claimed on the depletion. *Miller* *v. United States*, 24 A.F.T.R. 2d (P-H) 5363 (E.D. Okla. 1969).

IV. BASIS OF MINERAL PROPERTIES

A. *Acquisition Cost*

1. Generally

Only that portion of the basis of property attributable to the mineral property may be included in depletable basis under I.R.C. § 612.

(a) Operating Mineral Property

When an operating mineral property is acquired, the purchase price basis must be apportioned among all of the assets, including good will. *E.g.*, *Copperhead Coal Co. v. Commissioner*, 272 F.2d 45 (6th Cir. 1959). Under the regulations the cost basis of the mineral deposit is equal to that portion of the total cost that the value of the mineral deposit bears to the total value of the enterprise at the time of acquisition. Treas. Reg. § 1.611-1(d)(4); Rev. Rul. 69-539, 1969-2 C.B. 141. The regulations provide detailed rules regarding the methods and the factors to be taken into account in valuation. Treas. Reg. §§ 1.611-2(d)-2(e). For acquisitions after May 6, 1986, I.R.C. § 1060 requires that the residual method of valuing goodwill be applied in determining the basis of assets of a going business acquired by purchase. Thus, no portion of a premium may be allocated to mineral deposits.

(b) Commissions, Attorney's Fees, Etc.

Commissions and finders fees paid by a purchaser or lessee and attorney's fees incurred in the acquisition of a mineral property are included in depletable basis for the property. *See, e.g.*, *Fiore v. Commissioner*, 48 T.C.M. (P-H) ¶ 79,360 (1979); *Munger v. Commissioner*, 14 T.C. 1236 (1950); Rev. Rul. 67-141, 1967-1 C.B. 153.

2. Lessees

A lease bonus paid by the lessee is added to the lessee's depletable basis. Treas. Reg. § 1.612-3(a)(3). A production payment retained by the lessor will be treated as a lease bonus payable in installments, I.R.C. § 636(c). The lessee must capitalize the production payment (less the interest component) into depletable basis. Therefore, if the lessee claims percentage depletion, there will be no effective tax recovery of lease bonus payments.

Payments to secure an option to lease (or to acquire a fee interest to) a mineral property likewise should be capitalized. *See Commissioner v. Pickard*, 401 F.2d 615 (10th Cir. 1968). Royalties paid by the lessee, however, are excluded from gross income and not capitalized. *E.M.T. Coal Co. v. Commissioner*, 13 B.T.A. 124 (1928). The same rule applies to advance royalties. Treas. Reg. § 1.612-3(b)(3). If delay rentals are not deducted currently, under I.R.C. § 266 the payment will be added to the depletable basis in the lease. Treas. Reg. § 1.612-3(c). *See also* Rev. Rul. 80-49, 1980-1 C.B. 127.

If a lease is acquired as part of the acquisition of an operating mineral extraction enterprise, a portion of the total purchase price must be allocated to the lease. Rev. Rul. 69-539, 1969-2 C.B. 141. In at least two cases, however, the taxpayer successfully avoided allocating any portion of the purchase price to the depletable basis upon proof that the fair market value of the tangible assets of each acquired enterprise had a value equal to the purchase price. *Island Creek Coal Co. v. Commissioner*, 35 T.C.M. (P-H) ¶ 66,103 (1966); *Island Creek Coal Co. v. Commissioner*, 31 T.C.M. (P-H) ¶ 62,138 (1962).

B. Surface Rights

1. Deep Mining

When the surface and mineral rights are acquired together, the basis must be apportioned between the two. *See* Treas. Reg. § 1.612-1(b)(1). If the method of mining utilized does not destroy the surface, depletion is allowed only with respect to the portion of the basis allocated to the coal mineral deposit. *Potts Run Coal Co. v. Commissioner*, 19 B.T.A. 1 (1930) (*nonacq.*). X-2 C.B. 90.

2. Surface Mining

Determination of the depletable basis is much more difficult in the case of surface mining. In *Manchester Coal Co. v. Com-*

missioner, 24 B.T.A. 577 (1931) (*nonacq.*), the Board of Tax Appeals included the cost of the surface overlying coal to be strip mined in the depletable basis because the method of mining would completely destroy the surface area.

(a) Effect of Reclamation Obligation

The same result was reached in *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959) *aff'g in part, rev'g in part*, 29 T.C. 528 (1957), despite the existence of a requirement on the taxpayer to reclaim the surface upon conclusion of operations and the allowance of an accrual deduction reflecting the bonding reclamation obligation.

Treasury Regulation § 1.612-1(b)(1)(ii) provides that depletable basis does not include the residual value of land and improvements at the end of operations. Because present law requires the restoration of the surface, *see* 30 U.S.C. §§ 1201-1328 and I.R.C. § 468, added by the Tax Reform Act of 1984, authorizes deductions (at the taxpayer's election) for additions to reserves for mine reclamation and closing costs, it appears theoretically inconsistent to claim that the original basis of the surface can be added to the depletable basis of the mineral deposit.

The proper resolution of this issue is unclear. *Denise Coal Company* is the only case in which the facts possibly raised both the deductibility of reclamation expenses and the treatment of the cost basis of the disturbed surface, but the court did not grasp the complexity and arrived at an inconsistent resolution of the two issues.

Even *Denise Coal Company* did not squarely raise the issue regarding the basis of the original surface because in that case the taxpayer claimed percentage depletion. Accordingly, it was of no benefit to it to add the surface basis to depletable basis. Instead, it claimed a loss deduction under I.R.C. § 165. It was in the context of denying the loss deduction that the court said that the basis of the surface should be allocated to the depletable basis of the coal. The court could have simply denied the loss deduction and held that the basis originally allocated to the surface carried over to the reclaimed surface. Since it did not, if the original basis of the surface is added to the depletable basis of the mineral deposit, the reclaimed surface has a zero basis because the reclamation costs have been deducted. This will be true even if the taxpayer claimed percentage depletion and thereby realized no tax benefit from adding the basis of the surface to depletable basis of the mineral deposit.

(b) Premium Price

If the operator must acquire an entire tract, portions of which do not overlay the coal deposit, in order to obtain necessary surface rights and he must pay a premium for acreage not overlying the coal deposit, the premium may be added to the depletable basis of the coal deposit. *Beaver Dam Coal Co. v. United States*, 370 F.2d 414 (6th Cir. 1966), *rev'g*, 237 F. Supp. 106 (W.D. Ky. 1965).

(c) Adjacent Surface Rights

In *Geoghegan & Mathis, Inc. v. Commissioner*, 55 T.C. 672 (1971), *aff'd*, 453 F.2d 1324 (6th Cir. 1972), *cert. denied*, 409 U.S. 842 (1972) the taxpayer was required to capitalize into depletable basis the cost of acquiring an easement and relocating to the easement utility company power lines that ran across the surface which had to be moved in order to expand the mine. The Court of Claims reached a contrary result in *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (per curiam), allowing such expenses to be deducted under I.R.C. § 616 as mine development expenses. *Cushing Stone Co. v. United States*, 535 F.2d 27 (Ct. Cl. 1976) followed *Kennecott Copper Corp.*, but in *Cushing Stone Co.*, the taxpayer conceded that the cost of the easement itself was a capital expense and sought to deduct only the relocation expense.

3. Service Areas

The cost of acquiring surface areas to be used to service a mine or oil or gas well is not allocated to the depletable basis. Rev. Rul. 74-282, 1974-1 C.B. 150. Nor is any loss deduction available if the auxiliary land suffers a diminution in value that will be reflected in the amount realized upon a subsequent sale. *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd on this point*, 271 F.2d 930 (3d Cir. 1959).

Where the service area acquired commands a premium price attributable to pits or geographic features making it peculiarly suitable for dumping, and filling the pits will diminish the value of the land, the premium may be depreciated. Rev. Rul. 74-282, 1974-1 C.B. 150; *Sexton v. Commissioner*, 42 T.C. 1094 (1964) (*acq. in result*) (pits used for trash dump).

C. Exploration Expenses

1. Solid Minerals

Unless deducted pursuant to I.R.C. § 617, solid mineral exploration expenses must be capitalized and recovered through depletion. Treas. Reg. § 1.617-1(c); Rev. Rul. 77-188, 1977-1 C.B. 76. If mine exploration expenses previously expensed under I.R.C. § 617 are recaptured in income in the year the mine reaches the production stage pursuant to an election under I.R.C. § 617(b)(1)(A), the exploration expenditures will be added to the depletable basis of the mineral deposit. Treas. Reg. § 1.617-3(a)(2).

2. Oil and Gas

Oil and gas exploration expenses incurred to obtain data to determine whether to acquire or retain a mineral property must be capitalized into the depletable basis of the mineral property. *See Louisiana Land and Exploration Co. v. Commissioner*, 7 T.C. 507 (1946), *aff'd on other grounds*, 161 F.2d 842 (5th Cir. 1947); Rev. Rul. 77-188, 1977-1 C.B. 76. There is no election to deduct oil and gas exploration costs.

D. Exclusions From Depletable Basis

1. Mineral Development Expenditures

Even if development expenditures are capitalized under an I.R.C. § 616(b) election, the capitalized amount is not added to the depletable basis. *See* Treas. Reg. § 1.612-1(b)(1)(i); Treas. Reg. § 1.612-2(a). The capitalized development expenditures will be carried in a separate capital account. *See* I.R.C. § 616(c); *see* Part VI.B., *infra* (discussion of solid mineral development expenses).

2. Oil and Gas Development Expenses

Oil and gas intangible drilling and development expenses are generally deducted pursuant to I.R.C. § 263(c). Thus they are not added to the depletable basis of the deposit. If, however, the taxpayer has not elected to deduct IDC currently, IDC (other than those that relate to depreciable property, such as the installation of casing) must be capitalized and added to the depletable basis of the property. Treas. Reg. § 1.614-4(b).

3. Depreciable Property

Expenditures for machinery and equipment, structures, tipples, railroad sidings and other supporting structures, such as fan houses, powder houses and transformers, oil and gas pumping equipment, storage tanks, and transmission lines are capitalized and the cost recovered either under I.R.C. § 167 or I.R.C. § 168, unless they are mine expenses that may be expensed under the recession of the working face doctrine, *see* Treas. Reg. § 1.612-2(a). *See* Part VIII A, *infra*. This rule also applies to oil and gas production equipment that is not expensed as IDC under I.R.C. § 263(c).

V. EXPLORATION EXPENDITURES

A. Capitalization of Oil and Gas Exploration Expenditures

Geological and geophysical exploration expenditures incurred to obtain and accumulate data that will serve as the basis for the acquisition or retention of a mineral property must be capitalized into the depletable basis of the mineral property. *See Louisiana Land and Exploration Co. v. Commissioner*, 7 T.C. 507 (1946), *aff'd on other grounds*, 161 F.2d 842 (5th Cir. 1947); Rev. Rul. 77-188, 1977-1 C.B. 76. For oil and gas properties, there is no election to deduct these costs. However, a loss deduction may be allowed under I.R.C. § 165 upon abandonment of the property to which the exploration expenditures relate. *Harmon v. Commissioner*, 1 T.C. 40 (1942) (*acq.*) (loss allowed); *Henley v. United States*, 396 F.2d 956 (Ct. Cl. 1986) (loss denied). In *Gulf Oil Corp. v. Commissioner*, 87 T.C. 135 (1986), the taxpayer claimed an abandonment loss with respect to particular deposits within a lease on which it continued to pay delay rentals so as to develop other deposits within the lease. The court denied the loss deduction. Compare Rev. Rul 83-105, 1983-2 C.B. 51, which appears to sanction a loss deduction for geological and geophysical costs allocable to abandoned deposits within a retained lease.

Capitalization of oil and gas exploration expenses does not extend to the cost of drilling exploratory or "wildcat" wells, the primary purpose of which is to ascertain the existence of hydrocarbons, even if the taxpayer has no present intent to develop the property. *Gates Rubber Co. v. Commissioner*, 74 T.C. 1456 (1980) (*acq.*); *Standard Oil Co. v. Commissioner*, 68 T.C. 325 (1977). Rev. Rul 88-10, 1988-6 I.R.B. 5. Such expenditures are IDC deductible under I.R.C. § 263(c). *Id. But see* Rev. Rul. 80-342, 1980-2 C.B. 99 (denying IDC deductions for exploratory wells drilled to gather information on which to base decision whether or not to bid on government leases).

Under the doctrine of *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), ACRS or depreciation on property owned by the taxpayer and used for oil and gas exploration is not currently deductible but must be capitalized as an exploration expense.

B. *Deduction of Solid Mineral Exploration Expenditures*

1. Capitalization Absent Section 617 Election

Unless the taxpayer makes an election to deduct mine exploration expenditures under I.R.C. § 617, mine exploration expenses are capital expenditures that must be capitalized into the depletable basis of the mine in the year in which the expenditure has been made. *See* Treas. Reg. § 1.617-1(c); Rev. Rul. 77-188, 1977-1 C.B. 76.

2. Defining Exploration Expenditures

Section 1.617-1(a) of the Treasury Regulations describes exploration expenditures as expenses "paid or incurred . . . for ascertaining the existence, location, extent or quality of any deposit of ore or other mineral for which a deduction for depletion is allowable under I.R.C. § 613 (other than for oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit." The development stage begins "at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other minerals are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer." *Id.* Further clarification is provided by a series of examples that have incorporated Rev. Rul. 70-287, 1970-1 C.B. 146 and Rev. Rul. 70-289, 1970-1 C.B. 147 into the regulations. It is important to document when the mine reaches the development stage. *See* Grossman & Johnson, *Distinction Between Exploration and Development Expenditures in the Hard Minerals Industry*, 27 The Tax Lawyer 119 (1973).

3. Election to Currently Deduct Mine Exploration Expenditures

Rather than capitalize mine exploration expenditures in the year incurred, the taxpayer may elect to deduct such expenditures currently under I.R.C. § 617. Once made, the election is binding for all future years, unless revoked in accordance with Treas. Reg. § 1.617-1(c)(3). *See* Treas. Reg. § 1.671-1(c)(2)(iii). If an election is revoked, the effect is retroactive, and taxable income for all years for which the election had been in effect must be recomputed. Exploration expenses do not include the cost of the mineral property. Treas. Reg. § 1.617-1(b)(4). Exploration expenses do not include the cost of depreciable property, but ACRS or depreciation on depreciable property used for exploration is an exploration expense. Treas. Reg. § 1.617-1(b)(3).

4. Tax Preference Treatment

(a) Individuals and Corporations

I.R.C. § 56(a)(2) requires that mine exploration expenses allowable as a deduction under I.R.C. § 617 be capitalized and amortized ratably over a ten year period, beginning in the year in which the expenditures were made, by both individuals and corporations in computing the alternative minimum tax under I.R.C. § 55. In the case of a corporation, this rule applies even to the portion of mine exploration expenses subject to I.R.C. § 291(b). As a result, a mineral property will have a different basis for alternative minimum taxable income purposes than it will for regular tax purposes when computing gain or loss on a sale. Because mine exploration expenses are not currently deducted for minimum purposes, recapture of mine exploration expenses under I.R.C. § 617(b) when the mine reaches the production stage should be a negative adjustment in computing alternative minimum taxable income. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 441 (1987).

A taxpayer may elect under I.R.C. § 59(e) to deduct mine exploration expenses over a ten-year period instead of as provided in I.R.C. § 617. Any taxpayer that makes such an election does not take mine exploration expenditures into account under I.R.C. § 56 in computing the minimum tax. *See* I.R.C. § 59(e) (6). (This is because the effect of the election is to treat the expenditures for purposes of the regular income tax in the same manner that they are treated for purposes of the alternative minimum tax.) Additionally, such expenditures are not recaptured pursuant to I.R.C. § 617(b) upon the mine reaching the production stage. Exploration expenditures deducted under I.R.C. § 59(i) are, however, subject to recapture under I.R.C. § 617(d), or for property placed in service after December 31, 1986 under I.R.C. § 1254, as amended by the Tax Reform Act of 1986, upon the sale of other disposition of the property. *See* I.R.C. § 59(e)(5)(B).

(b) Corporations

Section 291(b)(1)(B) requires corporate taxpayers to reduce otherwise allowable exploration deductions by fifteen percent for all tax years beginning after December 31, 1982, by twenty percent for all taxable years beginning after December 31, 1984, and by thirty percent for all expenses paid or incurred after December 31, 1986 in taxable years ending after that date. If the amount that was disallowed was paid or incurred prior to January 1, 1987 in a taxable year ending before that date, the amount may be deducted under I.R.C. §§ 291(b)(2) and (3) over five years, beginning in the year that the expense is paid or incurred, at the same rate as applied to cost recovery for five year ACRS property, and treated as qualified for the investment tax credit under I.R.C. § 46. Exploration expenditures paid or incurred after December 31, 1986 in taxable years ending after that date are deductible ratably over a sixty-month period beginning with the month in which they are paid or incurred. The portion of the exploration expenditures subject to disallowance under I.R.C. § 291(b) does not enter into the taxpayer's depletable basis of the property. I.R.C. § 291(b)(5); *but see* I.R.C. § 291(b)(6) (as in effect for years prior to 1987).

Deductions allowed under I.R.C. § 291(b)(2) are treated as exploration expense deductions under I.R.C. § 617(a) for the purpose of computing exploration expenses recaptured under I.R.C. § 617(g). For expenditures incurred after December 31, 1986 in taxable years ending after that date with respect to properties placed in service after December 31, 1986, under I.R.C. § 1254 deductions for exploration expenses under § 291(b)(2) are treated as exploration expense deductions under I.R.C. § 617(a) in computing recapture under I.R.C. § 1254 upon a disposition, but there is no recapture under I.R.C. § 617(b) upon the mine entering the production stage. *See* I.R.C. § 291(b)(4)(B) (as in effect prior to the Tax Reform Act of 1986); I.R.C. § 291(b)(3) (as amended by the Tax Reform Act of 1986).

5. Recapture of Exploration Expenses

(a) Recapture on Mine Reaching Producing Stage

(1) Inclusion in Income

I.R.C. § 617(b) requires that a portion of previously deducted exploration expenses, termed "adjusted exploration expenditures," must be recaptured in the year that the mine reaches the production stage. *See* Treas. Reg. § 1.617-2. The taxpayer may elect between two alternative methods of recapture. Under I.R.C. § 617(b)(1)(A), the taxpayer may affirmatively elect to include the "adjusted exploration expenditures" in gross income. If the taxpayer so elects, the amount included in income with respect to each mine will be added to the depletable basis under I.R.C. § 612 of the mineral property (determined under I.R.C. § 614) of which the mine is a part. Although recaptured adjusted exploration expenses are included in gross income under I.R.C. § 61, they are not included in gross income from the property under I.R.C. section 613 for purposes of computing percentage depletion. Treas. Reg. § 1.617-3(a)(2). Recapture income under I.R.C.

§ 617(b) should not be included in alternative minimum taxable income since the I.R.C. § 617(a) deduction is not allowed in computing alternative minimum taxable income.

(2) Disallowance of Depletion Deductions

Alternatively, I.R.C. § 617(b)(1)(B) requires that in the absence of such an election, any depletion deduction under I.R.C. § 611, either cost or percentage, otherwise allowable with respect to the property will be disallowed until the cumulative disallowed depletion deductions equal the adjusted exploration expenses subject to recapture. *See* Treas. Reg. § 1.617-3(a)(1)(i), -3(d). Because this method of recapture does not result in any increase in depletable basis, the depletable basis of the deposit is not reduced by the amount of the otherwise allowable depletion deductions that has been disallowed. I.R.C. § 617(e)(1); Treas. Reg. § 1.617-3(d)(ii). To reflect the exclusion of I.R.C. § 617(b) recapture from alternative minimum taxable income, it would appear to be proper to recompute depletion for AMT purposes.

It is worth noting that the recapture rules apply on a property by property basis, not a mine by mine basis. Thus, I.R.C. § 613(b)(1)(B) recapture may result in the disallowance of depletion deductions with respect to a mine located on the same property, but otherwise unrelated to the mine with respect to which the exploration expenditures were incurred. This can be avoided, however, by an election under I.R.C. § 614(c)(2) to treat the two mines as separate properties.

(3) Time For Making Election

Unlike the initial election to expense or capitalize mine exploration expenditures, the taxpayer may choose annually which method of recapture to apply. Whichever method is elected, however, applies to all mines reaching the production stage in that year. Treas. Reg. § 1.617-3(a)(2).

(4) Adjusted Exploration Expenditures Defined

Adjusted exploration expenditures are defined in I.R.C. § 617(f)(1) as the amount by which exploration expenditures deducted in previous years, which but for the election would have been capitalized under I.R.C. § 612, exceed the reduction in the depletion allowance that resulted from the deduction rather than the capitalization of the expenditures. The purpose of this definition is to limit recapture to the net tax benefit derived under the expensing option. The deduction of exploration expenses reduces taxable income from the property for the purpose of computing the fifty percent of taxable income ceiling on percentage depletion. Treas. Reg. § 1.614-5(a). To the extent of such reduction of the fifty percent of taxable income limit percentage depletion, there is no recapture. House Report No. 1237, 89th Cong., 2d Sess., reprinted in 1966-2 C.B. 777, 785 gives detailed examples of the computation of adjusted exploration expenses.

(5) Effect of Recapture

Because of the recapture provisions, the option to deduct current exploration expenses generally does not result in a permanent deduction of an amount that would otherwise be reflected in depletable basis. Rather, it accelerates a portion of the depletion deduction to an earlier year than that in which it would ordinarily be taken.

Similarly, the choice between the two methods of recapture generally affects timing, but not aggregate taxable income. Under I.R.C. § 617(b)(1)(A) the taxpayer has a large amount of income in the year that the mine reaches the production stage but suffers no reduction in depletion deductions for subsequent years. Section 617(b)(1)(B) recapture, on the other hand, avoids the early inclusion in income but results in a loss in future depletion deductions that are in the aggregate equal to the immediate income that would have been recognized had subsection (A) recapture been elected. Generally, it is to the taxpayer's advantage to recapture exploration expenditures under I.R.C. § 617(b)(1)(B). If, however, in the recapture year the taxpayer has large losses or a net operating loss carryover, then recapture under subsection (A) is preferable. Otherwise, the possibility that the adverse effect of recapture might be spread over more than one year militates in favor of opting for recapture under subsection (B).

(b) Recapture Upon Disposition of Property Placed in Service Prior to January 1, 1987

(1) Generally

If a taxpayer has deducted mine exploration expenditures and disposes of the property prior to full recapture under I.R.C. § 617(b) of the previously deducted mine exploration expenses, I.R.C. § 617(d)(1) requires that the taxpayer recapture as ordinary income the lesser of (1) the unrecaptured "adjusted exploration expenditures" (defined in I.R.C. § 617(f)(1)) or (2) as the gain in the case of a sale or exchange or excess of the fair market value over the basis in the case of another disposition). *See* Treas. Reg. § 1.617-4(a)(1). Like other recapture sections, this provision generally overrides specific nonrecognition provisions. However, the same exceptions, such as transfers by gift, death and upon the organization of a partnership or corporation, that apply to I.R.C. § 1245 recapture also apply to I.R.C. § 617 recapture. I.R.C. § 617(d)(3); Treas. Reg. § 1.617-4(c). Recapture income under I.R.C. § 617(d) is not included in gross income from the property under I.R.C. § 613 for purposes of computing percentage depletion. *Id.* If the property is sold at a loss, there is no recapture. Treas. Reg. § 1.617-4(a)(4). Treas. Reg. § 1.617-4(a)(3) provides examples that illustrate the basic principle of I.R.C. § 617(d)(1).

(2) Disposition of Portion of Property

If a taxpayer disposes of only a portion of a mineral property (other than an undivided interest) with respect to which exploration expenses have been deducted and not fully recaptured, the unrecaptured adjusted exploration expense attributable to the entire property is attributed to the portion that the taxpayer disposed of. I.R.C. § 617(d)(2)(A). If the gain on the portion of the property disposed of is less than the unrecaptured exploration expenditures, then the balance remains subject to recapture with respect to the portion of the property that the taxpayer has retained. Treas. Reg. § 1.617-4(b)(1). On the other hand, if the taxpayer disposes of an undivided interest in the property, only a proportionate part of the adjusted exploration expenditures are attributed to the portion of the property which the taxpayer has disposed of. I.R.C. § 617(d)(2)(B).

For example, assume that A owns an 80 acre tract of land with respect to which he has deducted exploration expenditures under I.R.C. § 617(a). If A were to sell an undivided 40 percent interest in the property, 40 percent of the adjusted exploration expenditures with respect to the 80 acre tract would be treated as attributable to the 40 percent of the 80 acre tract disposed of (to the extent of the amount of the gain to which § 617(d)(1) applies). Treas. Reg. § 1.617-4(b)(2). However, recapture may be avoided if the taxpayer can establish that the expenditure related neither to the portion or interest of the property disposed of nor to any mine in the property held by the taxpayer before the disposition that has reached the production stage. *See* Treas. Reg. § 1.617-4(g)(3).

(c) Recapture Upon Disposition of Property Placed in Service After December 31, 1986

For property first placed in service after December 31, 1986, I.R.C. § 1254, as amended by the Tax Reform Act of 1986, governs recapture upon disposition of the property of previously expensed mine exploration expenditures. Section 1254(a)(1)(A)(i) provides that "expenditures which have been deducted . . . and which, but for such deduction would have been included in the adjusted basis of such property, . . . " shall be subject to recapture as ordinary income. The exact amount recaptured as ordinary income depends on the amount of depletion and development expense deductions claimed with respect to the property. Recapture will not exceed the gain realized. The interrelationship of I.R.C. § 1254 recapture and I.R.C. § 617(b) recapture is not explained in I.R.C. § 1254. Presumably, prior recapture under I.R.C. § 617(b)(1)(A) negates the application of I.R.C. § 1254 because, as a result of I.R.C. § 617(b)(1)(A) recapture, the expenses will be included in basis. But if the taxpayer elects recapture under I.R.C. § 617(b)(1)(B) through disallowed depletion deductions, I.R.C. § 1254 recapture will apply upon disposition notwithstanding the prior complete recapture of expensed exploration expenditures under I.R.C. § 617(b)(1)(B). As illogical as this may appear, it is consistent with the recapture of previously allowed depletion deductions, including cost depletion, as ordinary income under I.R.C. § 1254.

Section 1254 provides for exceptions to recapture and rules governing recapture upon disposition of less than the taxpayer's entire interest in the property that are substantially similar to those that apply under I.R.C. § 617(d). *See* Part VI.A.4., *infra*. As with transfers of property placed in service prior to 1987, a subsequent lease will not be considered to be a disposition, and I.R.C. § 617(c) will continue to govern recapture of exploration expenditures.

C. *Apportionment of Exploration Expenses Among Properties*

Exploration expenses covering a broad area must be allocated among the separate mineral properties to which they are attributable. If an election under I.R.C. § 617 has been made, exploration expenses must be further allocated among two or more mines to which they may be attributable. The rules promulgated by the I.R.S. for apportioning exploration expenses are set forth in Rev. Rul. 77-188, 1977-1 C.B. 76, as amplified by Rev. Rul. 83-105, 1983-2 C.B. 51. *See also* Treas. Reg. § 1.617-3(d)(3). These rules apply both to solid mineral properties and to oil and gas properties. Rev. Rul. 77-188, 1977-1 C.B. at 77.

Under the Rev. Rul. 77-188 approach, a loss deduction under I.R.C. § 165, which is not subject to any recapture, was allowable only upon the abandonment of a project area in which no area of interest was located. A loss deduction with respect to an area of interest was allowable only if no property was acquired or retained within or adjacent to that area of interest. Rev. Rul. 77-188, 1977-1 C.B. at 77. Project area costs, which are exploration expenditures incurred in connection with the exploration of a project area (a territory that the taxpayer determines can be advantageously explored in a single integrated operation), must be allocated among the "areas of interest" identified as a result of the survey of the project area. Each separate, noncontiguous portion of the project area on which is indicated a specific geological feature with sufficient mineral producing potential to warrant further exploration is an area of interest. Area of interest costs, which are exploration expenditures for more detailed exploration of an area of interest, must be allocated to the property or properties acquired or retained, if any, within or adjacent to the area of interest. Rev. Rul. 77-188, 1977-1 C.B. at 77.

Rev. Rul. 83-105, 1983-2 C.B. 51 "amplified" Rev. Rul. 77-188, in a series of examples making it easier for taxpayers to isolate exploration expenses with respect to particular properties and claim loss deductions for properties that are not acquired or are abandoned. Some general principles may be discerned from Rev. Rul. 83-105. There may be different areas of interest within a single leasehold if the taxpayer conducts separate unrelated detailed surveys (example 2B), or if a preliminary reconnaissance survey indicates distinct areas of interest (example 3). If less than all of the areas of interest within the leasehold are developed, a loss deduction under I.R.C. § 165 will be allowed with respect to exploration expenses initially allocated to an abandoned area of interest. A loss deduction may be allowed under I.R.C. § 165 for the geological and geophysical expenditures allocable to an area of interest within a single lease or within multiple contiguous leases if the area of interest is abandoned as a potential source of mineral production on the basis of negative information from the detailed survey, *even though* the taxpayer retains the lease or the contiguous leases because of facts such as (1) the existence of mineral production from a different surface geographical portion or different subsurface zone of the lease or leases than that surveyed, (2) the discovery of mineral production potential in a different surface geographical portion or different subsurface zone of the lease or leases than that surveyed, or (3) the hope of finding mineral producing potential in a different surface geographical portion or different subsurface zone of the lease or leases than that surveyed. *But see Gulf Oil Corp. v. Commissioner*, 87 T.C. 135 (1986). The exploration expenses incurred with respect to areas of interest within the lease that are not abandoned will be capitalized into depletable basis or deducted under I.R.C. § 617.

VI. DEVELOPMENT EXPENDITURES

A. *Oil and Gas Intangible Drilling and Development Costs*

1. Election to Deduct

Section 263(c) permits taxpayers to elect to deduct currently "intangible drilling and development costs" (hereinafter IDC) for oil and gas wells. The substantive rules governing the deduction are found in Treas. Reg. § 1.612-4. If the taxpayer does not elect currently to deduct IDC, the expenditures for items subject to the election, the cost of which are otherwise recoverable through depreciation or ACRS deductions, will be recovered under I.R.C. § 167 or I.R.C. § 168, but all other costs are capitalized as part of the depletable basis of the mineral property. Treas. Reg. § 1.612-4(b). If the hole is dry, a loss may be claimed only upon abandonment of the property, unless the operator elects to deduct currently the cost of nonproductive wells under Treas. Reg. § 1.612-4(b)(4).

IDC incurred after December 31, 1986 with respect to foreign wells are not eligible for expensing under I.R.C. § 263(c). Instead, I.R.C. § 263(i) provides that foreign IDC must be capitalized. The taxpayer may elect to include the capitalized IDC in the depletable basis of the property for purposes of computing the depletion allowance under I.R.C. § 611, thereby increasing cost depletion (but not percentage depletion). If an election is made, only those costs that are represented by physical property are covered through depletion. Cost represented by physical property, such as casing or offshore platform construction are recovered through depreciation. Rev. Rul. 87-134, 1987 - 51 I.R.B.J. For depreciation of foreign use property, *see* I.R.C. § 168(g). If no election is made, the IDC are recovered ratably over the ten-year period beginning with the year in which the IDC are incurred. These rules apply to any wells not in the fifty states, the District of Columbia or the continental shelf areas adjacent to United States territorial waters.

Only the holder of an operating interest may deduct IDCs. Treas. Reg. § 1.612-4(a). *See Phillips v. United States*, 233 F. Supp. 59 (E.D. Tex. 1964), *aff'd per curiam*, 353 F.2d 739 (5th Cir. 1965); *Hutchinson v. Commisioner*, 49 T.C.M. (P-H) ¶ 80,551 (1980). If the taxpayer agrees to pay all or part of the IDC for property in exchange for a grant of a fractional interest in the operating rights, only the IDC attributable to the fractional interest acquired may be deducted. The balance must be capitalized. Treas. Reg. § 1.612-4(a). A taxpayer who acquires a working interest in an already completed well is not entitled to deduct any portion of the price as IDC even if a portion of the purchase price represents a reimbursement of a proportionate share of IDC previously incurred by the seller. *Platt v. Commissioner*, 207 F.2d 697 (7th Cir. 1953); *Hass v. Commissioner*, 55 T.C. 43 (1970).

In *Stradlings Bldg. Materials, Inc. v. Commissioner*, 76 T.C. 84, 89 (1981) the Tax Court stated that in order for the taxpayer to claim the IDC deduction, "the payment or incurrence of the costs must occur sufficiently early in the development stages so that the taxpayer is exposed to the unknown risks of development." No court ever actually applies this standard, however. All drilling is eligible for the IDC election. No IDC deduction is allowed, however, for a well illegally bottomed outside the taxpayer's property. *Commissioner v. Donnell's Estate*, 417 F.2d 106 (5th Cir. 1969); Rev. Rul. 69-262, 1969-1 C.B. 166.

IDC are deductible whether incurred directly or through a turnkey contract. Treas. Reg. § 1.612-4(a). If the leasehold interest is also acquired from the turnkey driller, however, the allocation of the aggregate price between IDC and leasehold costs made by the parties will be respected only if it is reasonable. *Bernuth v. Commissioner*, 470 F.2d 710 (2d Cir. 1972). The I.R.S. will recognize as a reasonable amount of IDC that amount that does not exceed an arm's length charge that would be made by an unrelated drilling contractor. Rev. Rul. 73-211, 1973-1 C.B. 303.

In the case of a carried interest, the carrying party may deduct only the percentage of the IDC that represents his permanent interest in production unless he holds the entire interest during the entire payout period. The carried party is not entitled to deduct any IDC. *See United States v. Cocke*, 399 F.2d 433 (5th Cir. 1968), *cert denied*, 394 U.S. 911 (1969); Rev. Rul. 71-206, 1971-1 C.B. 105; Rev. Rul. 71-207, 1971-1 C.B. 160. Thus, if the carrying party is entitled to one hundred percent of production until he recoups all of his IDC and the production costs to operate the well to produce such amount, then the carrying party may deduct all of his IDC. If, on the other hand, the carrying party has a permanent one-quarter share but is entitled to a larger percentage of production, but not one hundred percent of production, until he has recouped, for example, one half of his IDC, only one fourth of the IDC are deductible. If the carrying party holds the complete working interest for the entire payout period and deducts all of his IDC, he nevertheless must capitalize at the end of the payout period as his depletable basis in his permanent interest the fraction of the undepreciated basis of well equipment attributable to the carried party's permanent interest. Rev. Rul. 71-207, *supra*. For other applications of the carried interest rules and farmouts, *see* Rev. Rul. 80-109, 1980-1 C.B. 129; Rev. Rul. 70-336, 1970-2 C.B. 145; Rev. Rul. 77-176, 1977-1 C.B. 78.

For a case that appears to have misapplied the carried interest rules so as to allow a deduction for one hundred percent of the IDC paid by a taxpayer that did not hold the entire working period until the end of the payout period, *see Huskey Oil Co. v. Commissioner*, 83 T.C. 717 (1984), *aff'd sub nom. Marathon Oil Co. v. Commissioner*, 60 A.F.T.R. 2d 5974 (10th Cir. 1987).

Under Treas. Reg. § 1.614-4(d) the election to deduct currently IDC must be made on the first return filed after such costs are incurred. The election may not be made on an amended return. *Goodall's Estate v. Commissioner*, 391 F.2d 775 (8th Cir. 1968). Once made, the election either to deduct or capitalize IDC is binding on the taxpayer for the year of the election and all subsequent years with respect to all properties owned by the taxpayer. Treas. Reg. § 1.614-4(e). An earlier election made as an individual, however, does not preclude a later inconsistent election by a partnership of which the taxpayer is a partner. *See Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953); Rev. Rul. 54-42, 1954-1 C.B. 64; Treas. Reg. § 1.703-1(b). Each corporation that is a member of an affiliated group filing a consolidated return under I.R.C. § 1501 also may make its own election.

Treas. Reg. § 1.613-5(a) requires that IDC be deducted in computing the fifty percent of taxable income from the property ceiling on percentage depletion. Rev. Rul. 77-136, 1977-1 C.B. 167, requires that a taxpayer who has elected to deduct IDC, also deduct, in computing the fifty percent of taxable income from the property ceiling on percentage depletion, the IDC incurred with respect to all wells drilled on one property in an attempt to reach the same production horizon. On the other hand, the cost of attempts to reach lower producing horizons, which prove to be unsuccessful, need not be deducted in computing taxable income from the producing property.

2. Tax Preference Treatment

(a) Generally for Taxable Years Beginning After December 31, 1986

Section 57(a)(2) treats a portion of intangible drilling and development costs as a tax preference item subject to minimum tax under I.R.C. § 55 for both individuals and corporations in taxable years beginning after December 31, 1986. A complex formula determines the amount of IDC that are a tax preference item. Under the formula, the amount by which "excess intangible drilling costs" for the taxable year is greater than sixty-five percent of the taxpayer's net income from oil and gas properties for the year will be a tax preference item. Net oil and gas income is determined without regard to deductions for excess IDC. Thus, for example, a taxpayer with $100 of net oil and gas income and $80 of excess IDC has a preference of $15, the amount by which the $80 excess IDC exceeds $65 ($100 net oil and gas income x 65%). "Excess intangible drilling costs" are IDC in excess of the amount that would be allowed as a deduction under I.R.C. § 263(c) or I.R.C. § 291(b), excluding amounts incurred with respect to dry wells, over the amount that would have been allowed as a deduction if IDC had been capitalized and deducted ratably over a one hundred twenty month period beginning in the month in which production from the well begins. Thus, the amount of the preference is a function of both the month of the year in which production begins and the delay between drilling and the commencement of production. Section 57(b)(2) permits the taxpayer to elect to use a recovery method allowable for cost depletion in lieu of one hundred twenty month amortization for the purpose of computing excess IDC.

Treatment of IDC as a tax preference item may be avoided by an individual or a corporation with respect to IDC incurred in years beginning after December 31, 1986 through an election to deduct the IDC under I.R.C. § 59(e) instead of under I.R.C. § 263(c). If the taxpayer so elects, IDC will be deducted ratably over a ten-year period beginning with the year in which the IDC are incurred. Section 291 is applied to corporations incurring IDC before I.R.C. section 59(e) is applied. I.R.C. § 59(f). A separate election must be made by each partner of a partnership incurring IDC. I.R.C. § 59(e)(4)(C).

(b) Special Rules for Corporations

Section 291(b)(1)(A) provides that any corporation that is an integrated oil company may currently deduct only eighty-five percent of the IDC otherwise deductible under I.R.C. § 263(c) for tax years beginning after December 31, 1982, only eighty percent for tax years beginning after December 31, 1984, and only seventy percent for taxable years beginning after December 31, 1986.

Disallowed IDC incurred for years beginning before January 1, 1987 are treated as a deferred deduction allowable ratably over the thirty-six month period beginning with the month in which the costs were paid or incurred. I.R.C. § 291(b)(2)(A) as in effect prior to the Tax Reform Act of 1986. Disallowed IDC incurred in years beginning after December 31, 1986 are deducted ratably over a sixty-month period beginning in the month in which the costs are paid or incurred. No investment tax credit under I.R.C. § 46 was allowed with respect to the capitalized IDC regardless of when incurred. Capitalized IDC are not taken into account for purposes of computing cost depletion. I.R.C. § 291(b)(5). These rules, however, are not intended to apply to dry wells, the cost of which apparently should be currently deductible as a loss. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, at 33 (1982). An "integrated oil company" subject to I.R.C. § 291(b)(1)(A) is a producer of crude oil within the meaning of I.R.C. § 4996(a)(1) that is not an "independent producer." Section 4996(a)(1) defines a producer as a "holder of the economic interest with respect to the crude oil." An independent producer is defined by I.R.C. § 4992(b) through cross references to I.R.C. §§ 613A(c) and (d) as any producer for whom percentage depletion under I.R.C. § 613A(d) is not disallowed because the taxpayer is neither a retailer under I.R.C. § 613A(c)(2) nor a refiner under I.R.C. § 613A(d)(4).

(c) Individuals In Taxable Years Before 1987

For years before 1987, intangible drilling costs were a tax preference item subject to the alternative minimum tax for individuals under IRC § 55, but IDC were not tax preference items for the corporate minimum tax under IDC § 56. (All citations in this paragraph to I.R.C. sections dealing with the alternative minimum tax are to I.R.C. as in effect before the Tax Reform Act of 1986.) The portion of the IDCs treated as a tax preference item was determined under I.R.C. § 57(a)(11). Only the amount of IDC in excess of both the amount that would have been allowable if IDC had been capitalized and recovered over one hundred twenty months using the straight line method of recovery, and the net income from all oil and gas properties of the taxpayer, computed without taking into account the amount of excess IDC deduction, constitutes a tax preference item.

Treatment of IDC as a tax preference item was avoidable by an individual with respect to IDC incurred (other than by holding a partnership interest in a limited partnership or by being a passive shareholder in a subchapter S Corporation) through an election to deduct the IDC under I.R.C. § 58(i)(4) instead of under I.R.C. § 263(c). If the taxpayer so elected, no current deduction was allowed for IDC, but the amount of IDC to which the election applied was eligible for the investment tax credit under I.R.C. § 46 and the IDC, reduced as required by I.R.C. § 48(q), will be recovered as deductions at the same rate as applies to five-year recovery property under ACRS. Even if an individual taxpayer had IDC through a limited business interest (as defined in I.R.C. § 58(i)(4)(C) and I.R.C. § 55(a)(8)(C)), he nevertheless could have avoided tax preference item treatment by electing to deduct the IDC under I.R.C. § 58(i) instead of currently deducting them under I.R.C. § 263(c). Under I.R.C. § 58(i), IDC were deducted ratably over ten years beginning in the year in which the expenses were incurred. No investment tax credit was allowed with respect to IDC capitalized and deducted under I.R.C. § 58(i).

3. Items Subject to Election

Section 1.612-4(a) of the Treasury Regulations states that the option to deduct IDC includes "all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." This includes such expenditures as those incurred in "drilling, shooting, and cleaning wells," . . . "clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells" . . . and "construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas."

Expenditures for items which have salvage value are not included within the IDC deduction option. *See Harper Oil Co. v. United States*, 425 F.2d 1335 (10th Cir. 1970) (surface casing required to be cemented under state law had salvage value even though removal was prohibited). Costs of labor, fuel, and supplies incurred to erect structures on the property and to drill wells do not ordinarily have salvage value. Treas. Reg. § 1.612-4(a). Both the Tax Court and the Court of Claims (now the Federal Circuit) have interpreted the option to deduct IDC very broadly, extending the option to many of the costs of onshore construction of offshore platforms. *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349, 388 (1981); *Gulf Oil Corp. v. Commissioner*, 87 T.C. 135 (1986); *Exxon Corp. v. United States*, 547 F.2d 548, 549 (Ct. Cl. 1976). As a result of these decisions, the line between eligible expenditures and ineligible expenditures is unclear, and the scope of the IDC deduction appears to be expanding beyond its historic limits.

Following litigation in which it contested the issue, the I.R.S. now concedes that costs of drilling expendable wells to determine the location and delineation of a deposit are subject to the IDC election, provided that the wells could have been completed as producing wells. Rev. Rul. 88-10, 1988-6 I.R.B.50. *See also Gates Rubber Co. v. Commissioner*, 74 T.C. 1456 (1980) (*acq.*).

IDC include only those costs incident to drilling or development; production costs are not included. Rev. Rul. 70-414, 1970-2 C.B. 132 (providing that the IDC election does not cover "expenditures relating to the installation of equipment such as pumping equipment, flow lines, separators, storage tanks, treating equipment and salt water disposal equipment"). A producing well has been completed when a "christmas tree" has been installed. The cost of installing property associated with production that is not eligible for the IDC deduction is recovered through depreciation or ACRS deductions. Drilling of injection wells for secondary recovery are IDC; however, even if the drilling occurs after the property has been producing, as long as the wells could have been completed as producing wells rather than injection wells. Tech. Ad. Memo. 8728004.

"Bottom hole" contributions are not deductible as IDC Rev. Rul. 80-153, 1980-1 C.B. 10.

4. Prepaid IDC

IDC are generally deductible in accordance with the taxpayer's method of accounting Thus, a cash basis taxpayer deducts IDC when paid, and an accrual taxpayer deducts IDC when incurred. However, I.R.C. § 461(h), enacted in 1984, now limits deductions for prepaid IDC by accrual basis taxpayers. The "all events" test necessary to accrue the deduction will not be met only when drilling begins. According to the I.R.S., a cash basis taxpayer may currently deduct prepaid IDC, even if a substantial portion of the work is not performed until a future year, only if the payment is actually a payment, rather than a refundable deposit, the deduction does not distort income, and the payment is required to be made for a legitimate business purpose. *See* Rev. Rul. 71-252, 1971-1 C.B. 146; Rev. Rul. 71-579, 1971-2 C.B. 225; Rev. Rul. 80-71, 1980-1 C.B. 106. The courts have applied a slightly different test. *Keller v. Commissioner*, 79 T.C. 7 (1982), *aff'd*, 725 F.2d 1173 (8th Cir. 1984), held that prepaid IDC were deductible only if (1) the payment was actually a payment and not a deposit, and (2) the prepayment does not result in a material distortion of income. Although the court found that a business purpose for the prepayment would be deemed to satisfy the "no material distortion" requirement, a business purpose for the prepayment was not treated as a separate requirement, rejecting the I.R.S. argument that it was. *See also Schiavenza v. United States*, 720 F.2d 1117 (9th Cir. 1983) (advances that are only deposits for payment of future costs may not be deducted until the services are performed). In addition, I.R.C. § 461(i) defers deductions for prepaid IDC for a cash basis tax shelter (as defined in the statute) until the year of economic performance.

5. Recapture of IDC Deductions

For properties placed in service before January 1, 1987, I.R.C. § 1254(a) requires that upon the sale or other disposition of any oil or gas property, the taxpayer includes in ordinary income, the lesser of (1) an amount equal to the "adjusted intangible drilling and development costs," reduced by the amount that would have been deductible had the IDC been capitalized and recovered through cost depletion; or (2) the gain realized from the disposition. *See* Prop. Reg. § 1.1254-1(a). The "adjusted intangible drilling and development costs" are equal to previously deducted IDC, reduced by the amount, if any, by which the depletion deduction was reduced (through the fifty percent of taxable income ceiling on percentage depletion) because the IDC was deducted rather than capitalized. *See* Prop. Reg. § 1.1254-1(a)(5) (specific examples of the computation).

For properties placed in service after December 31, 1986, an amount equal to the lesser of (1) all IDC previously deducted with respect to the property, not just "adjusted intangible drilling and development costs," or (2) the gain from the disposition of the property, is subject to recapture as ordinary income upon disposition. The exact amount of IDC subject to recapture depends on the amount of depletion claimed with respect to the property because IDC and depletion deductions are aggregated and subject to depletion. Total recapture income, however, will not exceed the gain realized (or the excess of fair market value over basis in a nonrecognition disposition).

Prop. Reg. § 1.1254-1(a)(3), defines an oil or gas property as an operating interest in an I.R.C. § 614(G) property or a nonoperating interest if the lessor previously held an operating interest against which IDC have been charged. It has been suggested that this definition combined with the definition of disposition in Prop. Reg. § 1.1254-1(a)(4), allows the sale of a carved out nonoperating interest to avoid recapture. *See* Burke & Bowhay, *1983 Income Taxation of Natural Resources* 1430 (1983). The position of the I.R.S. is that I.R.C. § 1254 recapture applies on the transfer of a carved out royalty or net profits interest. *See* Priv. Ltr. Rul. 8622005. Careful analysis of the issue indicates that the position of the I.R.S. is more consistent with the policy underlying the statute and should prevail. It is absolutely clear, however, that a subsequent lease or assignment with a retained economic interest is not a disposition that triggers I.R.C. § 1254 recapture.

Section 1254(b)(1) provides exceptions to recapture of IDC similar to the exceptions to I.R.C. § 1245 recapture in I.R.C. § 1245(b). *See* Prop. Reg. § 1.1254-2. Thus, there is no recapture upon gifts, transfers at death, contributions to a corporation or partnership, distributions by a partnership, or like kind exchanges.

Section 1254 recapture also applies to any IDC incurred by an integrated oil company that were not deducted under I.R.C.

§ 263(c) pursuant to I.R.C. § 291(b)(1)(A) to the extent that the IDC were deducted under I.R.C. § 291(b)(2)(A). *See* I.R.C. § 291(b)(4)(A), (as in effect prior to Tax Reform Act of 1986); I.R.C. § 291(b)(3). The treatment of the capitalized portion of an integrated oil company's IDC that have not yet been recovered under I.R.C. § 291(b)(2) at the time of sale of the property is unclear. TEFRA failed to specify whether the IDC, subject to I.R.C. § 291(b), were capitalized as part of the basis of the property, or as a separate asset. The Senate Finance Committee Report indicates that the IDC should be capitalized as part of the basis of the property, but the statute is silent on this point. S. Rep. No. 494, 97th Cong., 2nd Sess.

There is similar I.R.C. § 1254 recapture with respect to the IDC that an individual taxpayer elects to deduct under I.R.C. § 58(i), as in effect prior to the Tax Reform Act of 1986 (*see* I.R.C. § 58(i)(6)(A)) or that either a corporate or individual taxpayer elects to deduct under I.R.C. § 59(e). *See* I.R.C. § 59(e)(5)(A). If the taxpayer claimed the investment tax credit pursuant to an I.R.C. § 58(i)(4) election for years prior to 1986, there may also be investment tax credit recapture if the taxpayer disposes of the property within five years from the time that the IDC are incurred. I.R.C. § 58(i)(6)(B).

If the taxpayer disposes of only a portion of a property (other than an undivided interest) the entire amount of the IDC are allocated to the portion disposed of, but if not all IDC are recaptured upon the disposition, the balance are reallocated to the remaining property. I.R.C. § 1254(a)(2)(A); Prop. Reg. § 1.1254-1(b). If the taxpayer disposes of an undivided interest in the property, a proportionate part of the adjusted IDC are allocated to the portion disposed of. I.R.C. § 1254(a)(2)(B); Prop. Reg. § 1.1254-1(b)(2).

If an oil or gas property subject to I.R.C. § 1254 recapture is disposed of in an installment sale, the portion of each payment that represents gain is treated as I.R.C. § 1254 recapture income until all of the recapture income has been reported. Prop. Reg. § 1.1254-1(d). Section 453(i) does *not* apply to I.R.C. § 1254 recapture income.

As long as capital gains are not taxed more favorably than ordinary income, the primary effect of I.R.C. § 1254 recapture is to limit the taxpayer's ability to offset gains on the sale of a mineral property against losses realized on the sale of capital (but not I.R.C. § 1231) assets. Thus a loss on the sale of one working interest can offset I.R.C. § 1254 gain on another working interest; but I.R.C. § 1254 recapture gain cannot offset a loss recognized on the sale of a nonoperating interest (e.g., a purchased or retained royalty) if the nonoperating interest is a capital asset. *See* I.R.C. § 1211.

B. *Solid Mineral Development Expenses*

1. Current Deduction

(a) Domestic Mines

Section 616(a) provides for the current deduction of development expenditures of domestic mines or other natural deposits, other than oil and gas wells. Although both the Code and Regulations are silent on the issue, the I.R.S. asserts that only the holder of a working interest may deduct development expenses. *See* Rev. Rul. 77-308, 1977-2 C.B. 208; Tech. Adv. Memo. 8402013. This is a reasonable inference from the language of the regulations and the legislative history of I.R.C. § 616. Treas. Reg. § 1.616-1(b)(4) provides that a purchaser of a mineral property may not deduct any portion of the purchase price as a mine development expense even though prior mine development expenses incurred by the seller are reflected in the purchase price.

(b) Foreign Mines

Section 616(d) disallows any current deduction for foreign mine development expenses. Instead, such expenses are deferred and allowed ratably over a ten-year period, beginning with the year in which the expenses were paid or incurred. Alternatively, the taxpayer may elect to include mine development expenses in the depletable basis of the mineral deposit. Such an election is desirable if the taxpayer expects to claim cost depletion and the life of the deposit is expected to be less than ten years.

2. Election to Capitalize

A mine operator may elect under I.R.C. § 616(b) not to deduct mine exploration expenses, but to capitalize the expenditures and deduct them ratably as the mineral benefitted is produced. The election to capitalize and defer the deduction of development expenses under I.R.C. § 616(b), however, is restricted during the development stage to those development expenditures in excess of net receipts from the mine or deposit. Therefore, it is sometimes necessary to distinguish the development stage of a mine from the production stage. Under Treas. Reg. § 1.616-2(b), the production stage is reached "when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of developed ores of minerals rather than the development of additional ores of minerals for mining." The election to defer the deduction of mine development expenses is made annually on a mine-by-mine (not property) basis, Treas. Reg. § 1.616-1(c), Treas. Reg. § 1.616-2(e)(f)(4), and may not be revoked. Treas. Reg. § 1.616-2(e)(f).

Capitalized development expenses are added to the basis of the mineral property for purposes of I.R.C. § 1016(a) (i.e., for the purpose of computing gain or loss upon the sale or other disposition of the property), but not for the purpose of computing the depletion allowance. *See* I.R.C. § 616(c). Mine development expenses that have been deferred under I.R.C. § 616(b), and which have not yet been recovered through amortization deductions, are treated as part of the mine owner's adjusted basis in the mineral property for purposes of determining whether depletion deducted in any year exceeds the mine owner's adjusted basis in the property, and thus constitutes an item of tax preference to the mine owner under I.R.C. § 57(a)(8) (for years prior to 1987) or I.R.C. § 57(a)(1). *See* Priv. Ltr. Rul. 8315011.

Deferral of development expenses may have a negative impact on the allowable depletion deduction. Net operating loss carryovers under I.R.C. § 172 that arise from currently deducting development expenses are not deducted in computing the fifty percent of taxable income ceiling on percentage depletion. Rev. Rul. 60-164, 1960-1 C.B. 254. Deferred development expense deductions, however, are deducted in computing the fifty percent of taxable income ceiling in the year in which they are deducted in computing taxable income. Treas. Reg. § 1.613-5(c)(2).

3. Tax Preference Treatment of Deducted Development Expenses

(a) Individuals and Corporations in Taxable Years Beginning After December 31, 1986

Section 56(a)(2) requires that in computing the alternative minimum tax under I.R.C. § 55 both individuals and corporations capitalize and amortize ratably over the ten year period, beginning in the year in which the expenditures were made, mine development expenses allowable as a deduction under I.R.C. § 616. In the case of a corporation, this rule applies even to the portion of mine development expenses subject to I.R.C. § 291(b). As a result of I.R.C. § 56(a)(2), for both individuals and corporations, the basis of the mineral property will be different for minimum tax purposes than it will be for regular tax purposes.

A taxpayer may elect to deduct mine development expenses over a ten-year period under I.R.C. § 59(e). Any taxpayer that makes such an election does not take mine exploration expenditures into account under I.R.C. § 56 in computing the minimum tax under I.R.C. § 55. *See* I.R.C. § 59(e)(6). This is because the effect of the election is to treat the expenditures for purposes of the regular income tax in the same manner that they are treated for purposes of the alternative minimum tax.

(b) Special Rules for Corporations

Pursuant to I.R.C. § 291(b)(1), corporate taxpayers must reduce the development expense deduction otherwise allowable under I.R.C. § 616(a) by fifteen percent for taxable years beginning after December 31, 1982, twenty percent for taxable years beginning after December 31, 1984, and by thirty percent for taxable years beginning after December 31, 1986. The disallowed deduction for years prior to 1987, however, is capitalized, treated as a qualified investment for purposes of the investment tax credit, and deducted over five years utilizing the rate that applies to five-year ACRS property. I.R.C. § 291(b)(2)(V), (3) (as in effect prior to the Tax Reform Act of 1986). For years beginning after December 31, 1986, disallowed development expenses are allowed as a deduction ratably over the sixty-month period beginning with the month in which the expenses are paid or incurred. I.R.C. §

291(b)(2). If the taxpayer subsequently disposes of the property, any portion of the development expenditures that have been capitalized but not yet deducted under I.R.C. § 291(b)(2), presumably should be added to the basis of the property, although this is nowhere found in the statute. For expenses incurred prior to 1986, any such disposition within five years following the year in which the development expenditures were incurred will also trigger recapture of the investment tax credit under I.R.C. § 291(b)(4)(C) (as in effect prior to the Tax Reform Act of 1986). There should not, however, be any I.R.C. § 1245 recapture.

(c) Individuals for Taxable Years Before 1987

Section 58(a)(5) (as in effect prior to the Tax Reform Act of 1986), included as a tax preference item for purposes of the individual minimum tax under I.R.C. § 55, the amount of development expenses deducted under I.R.C. § 616(a) with respect to each mine or natural deposit in any year that exceeds the amount that would have been deducted in that year if the expense had been capitalized and deducted ratably over ten years beginning with the year in which the expenditure was made. To avoid tax preference treatment, the taxpayer could elect under I.R.C. § 58(i) (as in effect prior to the Tax Reform Act of 1986) to forego the benefit of I.R.C. § 616(a) and deduct the exploration expenditures ratably over ten years. A taxpayer who elected to defer development expense deductions and deduct the costs ratably over the life of the mine under I.R.C. § 616(a) had no concern with the minimum tax for this purpose.

4. Expenditures Qualifying as Mine Development Expenses

(a) General Principles

Neither the Code nor the Regulations provide a specific definition of mine development expenses. Treas. Reg. § 1.616-1(a) provides some guidance: "Development expenditures under I.R.C. § 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer." *See also* Treas. Reg. § 1.617-1(a) which defines exploration expenditures as those incurred prior to that time. Therefore, it is definitionally impossible to incur development expenditures during the exploration stage. Once the development stage has been reached, however, all development expenditures, whether incurred in the development or production stage, are deductible.

Section 616 is not applicable to expenditures that are otherwise deductible under any other provision of the Code. It applies only if in its absence the expenditures would have been added to depletable basis. Treas. Reg. § 1.616-1(b)(1). Section 616(a) specifically provides that expenditures for the acquisition or improvement of property of a character subject to the allowance for depreciation are not mine development expenses. However, depreciation on I.R.C. § 1231 assets utilized in development work will be a development expense. Treas. Reg. § 1.616-1(b)(2); *see also* Rev. Rul. 73-488, 1973-2 C.B. 207; Rev. Rul. 75-60, 1975-1 C.B. 179.

Treas. Reg. § 1.616-1(b)(3) provides that I.R.C. § 616 is applicable to development expenses paid in connection with the acquisition of a fractional share of the working interest only to the extent of the working interest acquired. The balance of the development expense must be capitalized into depletable basis as a cost of the working interest.

Cases and I.R.S. Rulings consistently have recognized that expenditures incurred to render the mineral in place accessible for mining or in preparing the mineral deposit for extraction are "mine development" expenditures subject to I.R.C. § 616. *See, e.g., Geoghegan & Mathis, Inc. v. Commissioner*, 453 F.2d 1324, 1327 (6th Cir. 1972), *cert. denied*, 409 U.S. 842 (1972); *Amherst Coal Co. v. United States*, 295 F. Supp. 421, 441 (S.D. W.Va.1969), *aff'd*, 27 A.F.T.R.2d (P-H) 358 (4th Cir. 1971) (per curiam); *H. G. Fenton Material Co. v. Commissioner*, 74 T.C. 584, 588 (1980); *Estate of DeBie v. Commissioner*, 56 T.C. 876, 891-92 (1971), (*acq.*) 1972-2 C.B. 1; Rev. Rul 74-549, 1974-2 C.B. 186; Rev. Rul. 74-282,1974-1 C.B. 150; Rev. Rul. 73-488, 1973-2 C.B. 207; Rev. Rul. 69-540, 1969-2 C.B. 143; Rev. Rul. 67-35, 1967-1 C.B. 159; Rev. Rul. 66-170, 1966-1 C.B. 159; Gen. Couns. Mem. 35,433. *See also* Gen. Couns. Mem. 13,954, XIII-2 C.B. 66, 73 (1934) (declared obsolete by Rev. Rul. 68-661, 1968-2 C.B.

607). As used in this context, the term "accessible" has been defined by the I.R.S. to mean the "work necessary to expose the ore surface."

The I.R.S. consistently asserts that I.R.C. § 616 applies only to expenditures that are incurred to perform some type of *physical mining* process or activity. *See, e.g.*, Rev. Rul. 74-282, 1974-1 C.B. 150; Rev. Rul. 73-488, 1973-2 C.B. 207; Rev. Rul. 67-35, 1967-1 C.B. 159; Rev. Rul. 66-170, 1966-1 C.B. 159. *But see Cushing Stone Co. v. United States*, 535 F.2d 27, 36 (Ct. Cl. 1976).

The I.R.S. also asserts that, to qualify as a mine development expenditure, an expenditure must represent an amount paid to permit the mine owner to exploit a deposit in which it already possesses the mining rights, as opposed to representing an amount paid to acquire the mining rights themselves. *See, e.g.*, Rev. Rul. 67-35, 1967-1 C.B. 159; Rev. Rul. 66-170, 1966-1 C.B. 159; *accord Geoghegan & Mathis, Inc.*, 55 T.C. 672 (1971), *aff'd*, 453 F.2d 1324 (6th Cir. 1972), *cert. denied*, 409 U.S. 842 (1972); *contra*, *Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965). This is theoretically consistent with Treas. Reg. § 1.616-1(b)(3).

(b) Specific Examples

Rev. Rul. 67-35, 1967-1 C.B. 159, held that the expenses of driving shafts, tunnels, and galleries in preparation for deep mining are development expenses under I.R.C. § 616. *See also* Rev. Rul. 69-540, 1969-2 C.B. 143. Generally, the I.R.S. has treated removal of overburden as an operating expense, as illustrated in Rev. Rul. 77-308, 1977-2 C.B. 208. *See also* Rev. Rul. 74-549, 1974-2 C.B. 186; Rev. Rul. 67-169, 1967-1 C.B. 159. However, in *National Lead Co. v. Commissioner*, 23 T.C. 988 (1955), *rev'd on other grounds*, 230 F.2d 161 (2d Cir. 1956), *aff'd*, 352 U.S. 313 (1957), for a year prior to the enactment of the predecessor of I.R.C. § 616, the I.R.S. unsuccessfully argued that the cost of stripping overburden and cutting benches was a development expense to be capitalized and recovered through depletion, rather than an operating expense. More recently, Rev. Rul. 86-83, 1986-1 C.B. 251 treated the cost of removal of overburden as a development cost when the removal was necessary to render accessible not only the mineral lying directly beneath the removed overburden, but also other portions of the deposit. Rev. Rul. 67-169, 1967-1 C.B. 159, and Rev. Rul. 77-307, 1977-2 C.B. 208 were distinguished.

Amherst Coal Co. v. United States, 295 F. Supp. 421 (S.D. W.Va. 1969), *aff'd*, 27 A.F.T.R.2d (P-H) 358 (4th Cir. 1971) (per curiam), held that constructing roads to provide access to a mine, even though the road would also be used for egress of the extracted mineral, was a development expense because the roads are analogous to tunnels. *See also Roundup Coal Co. v. Commissioner,* 20 T.C. 388 (1953) (cost of dual purpose escape way — coal egress "rock slope" was a development expense). *Compare* Rev. Rul. 73-488, 1973-2 C.B. 207, in which the I.R.S. held that the cost of constructing a road for the sole purpose of transporting equipment and supplies from the closest seaport to an unaccessible mine in a foreign country were not mine development expenditures. Rather, the cost of the road was to be capitalized and recovered by depreciation or amortization over a period not longer than the term of the mining concession granted by foreign governments.

Rev. Rul. 74-282, 1974-1 C.B. 150 held that no part of the cost of acquiring land adjacent to a surface mine for use as a dumping area for overburden was a development expense even though the land commanded a premium price due to existence of an exhausted open pit mine that could be filled with the overburden. The entire cost of the property was required to be capitalized, but the amount of the premium was subject to depreciation based on the capacity of the pit and the rate at which it would be filled with overburden. *But see Kennecott Copper Corp. v. United States*, 347 F.2d 275 (Ct. Cl. 1965) (per curiam) (treating as a deductible expense the cost of an easement to provide a dumping area for overburden).

Expenses to maintain a mineral property, such as fencing and building repair during years in which there is no physical mine development, are not deductible as development expenses but as ordinary and necessary business expenses under I.R.C. § 162 or expenses for the maintenance and conservation of income producing property under I.R.C. § 212. *Davis v. Commissioner*, 25 T.C.M. (P-H) ¶ 56,166 (1956).

Repairs to equipment used in mine development are subject to I.R.C. § 616. *Bryan's Estate v. Commissioner*, 32 T.C.M. (P-H) ¶ 63,182 (T.C.), *aff'd and rev'd on other grounds*, 362 F.2d 751 (4th Cir. 1966); *Ranchers Exploration & Dev. Corp. v. United States*, 42 A.F.T.R.2d (P-H) 5561 (D. N.M. 1978), *aff'd*, 634 F.2d 487 (10th Cir. 1980).

H.G. Fenton Material Co. v. Commissioner, 74 T.C. 584 (1980) held that the expenses (including legal fees, engineering fees, environmental impact report, filing fees, etc.) of obtaining special use permits from a local government to authorize mining activities were *not* development expenditures, but rather capital expenditures to be added to the depletable basis of the mine. The logic of this decision should extend to obtaining permits under SMCRA. *See generally*, Note, *Taxation of Expenditures Required by the Surface Mining Control and Reclamation Act of 1977*, 2 J. Min. L. & Pol'y 161 (1986-87).

Tech. Adv. Mem. 8503006 determined that the cost of an environmental impact study used to obtain state and federal permits necessary to operate a mine could not be currently deducted. Because the study was used over the life of the mine, it was a separate asset, the cost of which was to be capitalized and amortized over the life of the mine.

5. Relationship of Development Expense Deduction To Depletion Deduction

Mine development expenses, even if capitalized under I.R.C. § 616(b), are entirely deductible in addition to percentage depletion. However, mine development expenses must be deducted for purposes of computing the fifty percent of taxable income ceiling on percentage depletion in the same year in which they are deducted for purposes of computing taxable income. Furthermore, even though deferred development expenses are not added to depletable basis, to the extent that percentage depletion is claimed in excess of percentage depletion, it reduces the unamorized addition to basis under I.R.C. § 616. Thus, if upon disposition of a mining property, the mine owner has unrecovered mine development expenses that have been deferred under I.R.C. § 616(b), and total depletion claimed with respect to minerals produced and sold from the mine exceeds the owner's adjusted basis in the mine, to the extent of such excess, the owner will not recognize any tax benefit through a deduction of development expenses that it elected to defer and has not yet recovered if the mine is sold. *See* Rev. Rul. 75-451, 1975-2 C.B. 330. A disposition of the property through a leasing transaction, rather than a sale, however, will enable the mine owner to avoid a loss of tax benefits attributable to development expenses that it has elected to defer and which remain unrecovered because he will continue to claim deferred deductions under the lease. *See* Treas. Reg. § 1.616-2(c)(1).

6. Recapture of Mine Development Expenses on Disposition

For property first placed in service after December 31, 1986, I.R.C. § 1254, as amended by the Tax Reform Act of 1986, requires that previously deducted mine development expenditures be recaptured as ordinary income upon disposition of the property. Section 1254(a)(1)(A)(i) provides that "expenditures which have been deducted . . . and which, but for such deduction would have been included in the adjusted basis of such property, . . . " shall be subject to recapture as ordinary income. Section 291(b)(3) provides that I.R.C. § 1254 recapture of development expenses extends to development expenses subject to deferred deduction under I.R.C. § 291. Section 59(e)(5)(A) provides that I.R.C. § 1254 recapture applies to development expenditures deducted over the optional ten-year amortization period. Both of these rules are consistent with the recapture of previously allowed depletion deductions, including cost depletion, as ordinary income under I.R.C. § 1254. There is no recapture of development expense deductions with respect to property placed in service by the taxpayer prior to January 1, 1986.

Section 1254(b)(1) provides exceptions to recapture of IDC similar to the exceptions to I.R.C. § 1245 recapture in I.R.C. § 1245(b). *See* Prop. Reg. § 1.1254-2. Thus, there is no recapture upon gifts, transfers at death, contributions to a corporation or partnership, distributions by a partnership, or like kind exchanges. A subsequent lease should not be considered to be a disposition for purposes of I.R.C. § 1254. Accordingly, as long as capital gains do not receive more favorable treatment than ordinary income, I.R.C. § 1254 is of little practical importance; its primary role is to affect the ability to deduct capital losses.

If the taxpayer disposes of only a portion of a property (other than an undivided interest), the entire amount of the development expenses previously deducted are allocated to the portion disposed of. If the taxpayer disposes of an undivided interest in the property, a proportionate part of the adjusted IDC is allocated to the portion disposed of. I.R.C. § 1254(a)(2)(B); Prop. Reg. § 1.1254-1(b)(2). If not all development expenses are recaptured upon the disposition, the balance is reallocated to the remaining property. I.R.C. § 1254(a)(2)(A); Prop. Reg. § 1.1254-1(b).

If a mineral property subject to I.R.C. § 1254 recapture is disposed of in an installment sale, the portion of each payment that represents gain is treated as I.R.C. § 1254 recapture income until all of the recapture income has been reported. Prop. Treas. Reg. 1.1254-2(d). I.R.C. § 453(i), denying installment reporting to I.R.C. §§ 1245 and 1250 recapture income, does *not* apply to I.R.C. § 1(c).

VII. PERCENTAGE DEPLETION: DETAILS OF COMPUTATION

Percentage depletion for solid minerals is determined by multiplying the appropriate percentage from I.R.C. § 613(b) by the taxpayer's gross income from the property. Oil and gas percentage depletion under I.R.C. § 613A is equal to fifteen percent of the gross income from the property, subject to the 1,000 barrel per day limitation discussed in Part I.B.3., *supra*. "Gross income from the property" is a term of art that is not defined in the Internal Revenue Code. Although not precisely the same as gross income under I.R.C. § 61, the concept is similar. But one must always be wary of the differences.

A. *Exclusion of Rents and Royalties Paid*

The total depletion allowance with respect to any property must be apportioned between the owners of various interests in the deposit. Thus, I.R.C. § 613(a) requires that rents and royalties paid to a lessor or other holder of an economic interest be excluded from a lessee's gross income from the property. The purpose of this exclusion is to prevent two taxpayers from claiming depletion on the same income from the property as it passes through their hands successively. *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934). It reflects the view that the holders of economic interests in a mineral deposit are merely dividing the income among themselves. Because lessors of coal or domestic iron ore eligible for I.R.C. § 631(c) treatment may, for any year in which capital gains are taxed at a preferential rate, receive an even more generous allowance than merely claiming depletion on ordinary income royalties, it is appropriate to exclude from a lessee's gross income mining royalties paid to a lessor that is eligible for I.R.C. § 631(c) treatment. *See* Treas. Reg. § 1.613-2(c)(5) (i) (Ex.). A royalty holder need not be in the chain of title to the deposit for royalties to be excludable by the payor. Royalties paid to a person with any economic interest, such as a surface owner, *see Omer v. United States*, 329 F.2d 393 (6th Cir. 1964), are excluded from the payor's gross income from the property.

It is important to note the treatment of various payments that are considered royalties.

Advance royalties are excluded from gross income from mining in the year in which they are deductible in computing taxable income under I.R.C. § 63. Treas. Reg. § 1.612-2(c)(5)(iii). Pursuant to Treas. Reg. § 1.612-3(b)(3), advance royalties generally are deductible in the year of the sale of the mineral to which they relate, not in the year of payment. Certain uniform advance *minimum* royalties, however, are deductible in the year paid. *See* Part IX.B.5, *infra*. Notwithstanding the dictates of the regulations to the contrary, the I.R.S. has ruled that these minimum advance royalties are excluded from gross income from the property only in the year of sale of the production to which they relate. Rev. Rul. 79-386, 1979-2 C.B. 246. This generally has the effect of reducing allowable percentage depletion.

The purported payment of advance royalties by the delivery of a promissory note payable only out of future production will not be treated as a payment of advance royalties. *See, e.g., Maddrix v. Commissioner*, 83 T.C. 613 (1984), *aff'd*. 780 F.2d 946 (11th Cir. 1986); *Wing v. Commissioner*, 81 T.C. 17 (1983); *Wasserstrom v. Commissioner*, 55 T.C.M. (P-H) ¶ 86,417 (1986).

Lease bonus payments are not excluded in the year of payment. That portion of the bonus allocable to the mineral sold in each year is excluded from gross income from mining in the year of sale of the mineral for purpose of computing percentage depletion. Treas. Reg. § 1.613-2(c)(5)(ii); Rev. Rul. 79-73, 1979-1

C.B. 218. The enactment of I.R.C. § 613A(d)(5) denying any percentage depletion allowance with respect to bonuses or advance royalties received by a lessor of an oil or gas property should not affect this result because the bonus or advance royalty is still depletable income for purposes of computing cost depletion.

Notwithstanding its exclusion from "gross income from the property," the allocable portion of the lease bonus payment is not excluded from gross income under I.R.C. § 61. *Sunray Oil Co. v. Commissioner*, 147 F.2d 962 (10th Cir. 1945); Rev. Rul. 79-73, 1979-1 C.B. 218. The lease bonus payment is a capital expenditure to be recovered through depletion. Treas. Reg. § 1.612-3(a)(3). But if percentage depletion is claimed, there is no effective recovery. Production payments retained by a lessor in addition to a separate royalty interest are treated as a lease bonus paid in installments. I.R.C. § 636(c).

Delay rentals are not "rents or royalties" within the meaning of I.R.C. § 613. Treas. Reg. § 1.612-3(c).

To be excludable as a royalty, payments need not be specifically designated as royalties. Rental payments for the use of plant and equipment of the lessor of a mineral deposit have been held to be excluded as royalties if the rent is expressed as a royalty based on units of mineral produced. *Leechburg Mining Co. v. Commissioner*, 15 T.C. 22 (1950); Rev. Rul. 68-361, 1968-2 C.B. 264. But payments to a lessor of plant and equipment or service land areas who is not also the lessor of the deposit are not royalties. *Brown v. Commissioner*, 22 T.C. 58 (1954).

Churchill Farms, Inc. v. Commissioner, 38 T.C.M. (P-H) ¶ 69,192 (1969), *modified sub. nom.*, *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971) (without discussion of this issue) held that a lessee's reimbursement of the lessor's legal fees incurred in connection with the lease of a mineral deposit was gross income from the property for the lessor. Accordingly, the lessee should exclude such items from gross income from the property. Since the payment does not relate to units extracted, it may be a lease bonus.

Payment by a lessee of *ad valorem* taxes levied on minerals in place imposed on the lessor under state law constitutes additional royalties. Rev. Rul. 72-165, 1972-1 C.B. 177; Rev. Rul. 75-182, 1975-1 C.B. 176. In Rev. Rul. 72-165, 1972-1 C.B. 177, the I.R.S. ruled that payment of *ad valorem* taxes in excess of the lessee's income from current production is a delay rental, not a royalty. The Tax Court had previously held to the contrary. *McLean v. Commissioner*, 54 T.C. 569 (1970). Payment by a lessee of the lessor's taxes imposed on the surface should also be treated as a royalty if the lessor leases both the surface and the coal to the lessee. *Thornton v. Commissioner*, 39 T.C.M. (P-H) ¶ 70,321 (1970).

If the lessee pays severance taxes for which the lessor is primarily liable, the taxes so paid constitute an additional royalty. *Louisiana Land and Exploration Co. v. Donnelly*, 394 F.2d 273 (5th Cir. 1968). Payment of severance taxes imposed on the taxpayer, however, are not treated as royalties. *See* Rev. Rul. 85-16, 1985-1 C.B. 180 (payments under Ontario Mining Tax are not royalties because province did not hold an economic interest in the minerals); *Ocean Drilling and Exploration Co. v. United States*, 600 F.2d 1343 (Ct. Cl. 1979) (payments to United States government under 43 U.S.C. § 1335(a)(9)).

B. Gross Income From the Property

1. Generally

The underlying purpose of the "gross income from the property" concept is to separate the proceeds of the producer's operations into the portion derived from the extraction of minerals and the portion derived from processing or manufacturing the extracted minerals, and to permit percentage depletion to be computed only with respect to the portion of the receipts attributable to the extraction.

(a) Oil & Gas

In the case of oil and gas wells, Treas. Reg. section 1.613-3(a) defines "gross income from the property" as "the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well." The regulations further provide that "if the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation." *Id.*

For oil and gas, the representative market or field price method for constructively determining gross income from the property is virtually mandatory. Efforts by either taxpayers or the I.R.S. to apply a workback formula (subtracting from the sales proceeds of manufacturing plants the costs of processing, including depreciation, plus a reasonable return to invested capital) or the proportionate profits method (which as provided in Treas. Reg. § 1.613-4(d)(4) for solid minerals, treats each dollar of cost of the product as earning the same profit) have not been approved by the courts. *See, e.g., Shamrock Oil & Gas Co. v. Commissioner*, 346 F.2d 377 (5th Cir. 1965), *cert. denied*, 382 U.S. 892 (1965); *Panhandle Eastern Pipeline Co. v. United States*, 408 F.2d 690 (Ct. Cl. 1969); *Hugoton Production Co. v. United States*, 315 F.2d 868 (Ct. Cl. 1963).

The I.R.S. has ruled that production includes only gravity separation of water and hydrocarbons (including separation of lighter and heavier hydrocarbons, in the field or at the plant. Any further processing, such as absorption or fractionation constitutes processing and necessitates the use of a representative market or field price. *See* Rev. Rul. 75-6, 1975-1 C.B. 178 (compression of natural gas to meet specifications of purchasing pipeline company, which enabled producer to realize a higher sales price, was a manufacturing process); *Brea Cannon Oil Co. v. Commissioner*, 77 F.2d 67 (9th Cir. 1935) (extraction of casinghead gasoline from wet gas is a manufacturing process).

The courts have supported the I.R.S. position with respect to fractionation, but have treated absorption as a production process when the dry gas is removed in a cycling plant that injects the gas into the reservoir to enhance production. *See Estate of Weinert v. Commissioner*, 294 F.2d 750 (5th Cir. 1961); *La Gloria Oil & Gas Co. v. Schofield*, 171 F. Supp. 617 (W.D. Tex. 1957), *rev'd on other grounds*, 268 F.2d 699 (5th Cir. 1959), *cert. denied*, 361 U.S. 933 (1960). But where the dry gas was sold, absorption has been treated as a manufacturing process. *Mountain Fuel Supply Co. v. Commissioner*, 449 F.2d 816 (10th Cir. 1971).

A special problem is presented when oil or gas is removed from the property and stored prior to sale. Treas. Reg. § 1.613-3(a) requires the use of a representative market or field price whenever oil or gas is transported off the property before sale. Accordingly, in Rev. Rul. 76-2, 1976-2 C.B. 533, the I.R.S. ruled that when oil or gas transported off the property is stored prior to sale and not sold until a future year, the depletion allowance is not deducted until the oil or gas is sold, but it is computed with reference to the representative market or field price at the time the oil or gas was transported from the property in the earlier year. Because in all likelihood the stored oil or gas was comingled with other fungible oil or gas, the required tracing is impossible.

(b) Solid Minerals

(1) Generally

Determination of gross income from the property in the case of solid minerals may be much more complex. I.R.C. § 613(c)(1) provides that gross income from the property in the case of solid minerals means "gross income from mining." In turn, "gross income from mining" means the "amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation of up to fifty miles from the point of extraction to the plants or mills where a treatment process considered as mining is applied." Sections 613(c)(2)-(c)(4) provide definitions of mining and a list of treatment processes considered as mining. Detailed rules for ascertaining gross income from mining are provided in Treas. Reg. § 1.613-4.

Gross income from mining for the holder of a working interest is the amount for which the mineral is sold, less trade and cash discounts, if no nonmining processes or nonmining transportation has been applied to the mineral. Treas. Reg. §§ 1.613-4(b)(1) to (4)(e)(l). Selling expenses, such as sales agent's commissions are not excluded from gross income from mining. Rev. Rul. 60-98, 1960-1 C.B. 252. Profits received by a broker who purchases the extracted mineral and resells for his own account are *not* included in an operator's gross income from mining. *See generally Camp Concrete Rock Co. v. United States*, 181 F. Supp. 806 (S.D. Fla. 1959), *aff'd*, 276 F.2d 211 (5th Cir. 1960) (per curiam); *Oliver Iron Mining Co. v. Commissioner*, 10 T.C. 908 (1948); Rev. Rul. 60-98, 1960-1 C.B. 252.

If nonmining processes or nonmining transportation is applied to the mineral, the entire sales price does not represent gross income from mining; only a portion of the sales price will be included in gross income from mining. Gross income from mining must be determined under the representative market or field price method or under the proportionate profits method. Treas. Reg. §§ 1.613-4(c) and 4(d).

(2) Treatment Processes Considered As Mining

Section 614(c)(4) sets forth with specificity the treatment processes for various minerals eligible for percentage depletion that are considered as mining. Sections 614(c)(4)(C) and (c)(4)(D) are the most broadly applicable. Section 614(c)(4)(C) applies to iron ore, bauxite, ball and sauger clay, rock asphalt, and *any* ore or mineral customarily sold in the form of a crude mineral product. The allowable processes are sorting, concentrating, sintering, and substantially equivalent processes to bring the mineral to shipping grade and form, and loading for shipment. Section 614(c)(4)(D) applies to lead, zinc, copper, gold, silver, uranium, and flourspar ores, potash, and any other ore or mineral *not* customarily sold as a crude mineral product. Allowable processes include crushing, grinding, beneficiation by concentration, cyandation, leaching, crystallization, precipitation, or substantially equivalent processes used to separate or extract the product from the ore or minerals from other material from the deposit. For an example of a "substantially equivalent process," *see Union Carbide Corp. v. Commissioner*, 75 T.C. 220 (1980), *aff'd on other grounds*, 671 F.2d 67 (2d Cir. 1982). Treatment processes specifically considered as mining for coal under I.R.C. § 613(c)(4)(A) are: cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment. *See also* Treas. Reg. §§ 1.613-3(a), (f)(1). Other subsections deal with *additional* processes allowable for a few specific minerals. Many of the terms that are significant for purposes of interpreting I.R.C. § 613(c)(4) are defined in Rev. Proc. 78-19, 1978-2 C.B. 491.

Any treatment "necessary or incidental" to the statutory processes will also be treated as mining. This is a factual determination, but Treas. Reg. § 1.613-4(f)(2)(iii) provides some guidance, as follows:

> A process is "necessary" to another related process if it is prerequisite to the performance of the other process. . . . A

> process is "incidental" to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal, prior to loading for shipment, with dots of paper to identify the coal for trade-name purposes will be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process.

Although storage prior to shipment is not specifically included among "treatment processes considered as mining" in any subsection of I.R.C. 613(c)(4), in *Ideal Basic Industries, Inc.*, 82 T.C. 352 (1984), the Tax Court held that storage prior to loading for shipment to the customer and loading for shipment, neither of which are specified in I.R.C. § 614(c)(1)(D), were treatment processes considered as mining for potash — a (D) mineral. To the extent that this decision is correct — and it appears to be well reasoned — storage prior to loading for shipment to the customer of an I.R.C. §614(c)(4)(C) mineral or of coal should be treated as a mining process.

Section 613(c)(5) specifies certain processes that cannot be considered as mining unless they are necessary or incidental to any of the processes treated as mining. *See* Treas. Reg. § 1.613-4(g)(1); Treas. Reg. § 1.613(6). Among the prescribed processes are electrolytic deposition, roasting, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change and thermal action. For example, coking of coal is a "thermal action" effecting a chemical change that is not a mining process. Similarly, liquification or gasification of coal would be a nonmining process under these standards. For examples of the difficulty of applying these rules, *compare Sunshine Mining Co. v. United States*, 827 F.2d 1404 (9th Cir. 1987) (electrowinning of copper is refining, not an allowable treatment process under I.R.C. § 613(c)(4)(D)), *with Ranchers Exploration and Development Corp. v. United States*, 634 F.2d 487 (10th Cir. 1980) (electrowinning of copper is an allowable treatment process).

Finally, the regulations provide that the application of any nonmining process (other than nonmining transportation) cuts off the mining phase of operations and the subsequent application of what would have otherwise been a mining process will not be considered as such. Treas. Reg. § 1.613-4(g)(2). For example, loading coked coal for shipment would not be a mining process. The Tax Court and Second Circuit have declined to apply this so called "sudden death" rule strictly in all circumstances. *See Barton Mines v. Commissioner*, 446 F.2d 981 (2d Cir. 1971), *aff'g in part, rev'g in part*, 53 T.C. 241 (1969), but the I.R.S. continues to assert its validity. *See* Rev. Rul. 73-540, 1973-2 C.B. 203 (loading for sale not a mining process if it occurs after a non-mining process); Rev. Rul. 74-400, 1974-2 C.B. 179.

Treatment processes that may be considered as mining are actually considered to be mining only if they are applied by the mine owner or operator. I.R.C. § 613(c)(4); Treas. Reg. § 1.613-4(f)(2) (iv). Treatment processes applied by a purchaser are not mining even though they would have been considered as mining if applied by the mine owner or operator. Treas. Reg. § 1.613-4(f)(2)(iv). *McClelland v. Commissioner*, 83 T.C. 958 (1984); *Rowe v. United States*, 655 F.2d 1065 (Ct. Cl. 1981); *Nicewonder v. United States*, 48 A.F.T.R.2d (P-H) 6039 (W.D. Va. 1981).

The requirement that the operator apply treatment processes in order for them to be considered mining should not be construed to require that the operator use his own employees. Processes applied by an independent contractor on behalf of the operator should meet the requirement as long as the operator retains title to the mineral through the processing. Substance must prevail over form, however, as illustrated by Rev. Rul. 74-568, 1974-2 C.B. 183. In that ruling, a mine operator, X, leased a coal deposit from Y. Under a separate agreement, X sold coal to Y at an agreed upon price of $10.75 per ton for washed coal (including $1 per ton for transportation) or $9.25 per ton for unwashed coal (including 1x dollars per ton for transportation). A third agreement provided that Y would crush and wash, on X's behalf, coal mined from the leased property and sold to Y at the charge of $1.50 per ton. The agreement did not provide for crushing and washing coal to be sold to anyone else. The I.R.S. concluded that notwithstanding the existence of separate contracts, in substance, the actual agreement between the parties was for the sale of unwashed coal. Therefore, the crushing and washing costs were excluded from X's gross income from mining. Furthermore, since X did not apply any mining processes at the point of delivery, the transportation component of the delivered price was not mining transportation.

A different result regarding both the washing and crushing costs and the transportation costs may have been reached if X had a general contract with Y for washing substantially all of the coal mined by X, and Y did not purchase substantially all of the coal washed under the agreement.

(3) Mining Transportation

Mining transportation includes only transportation not in excess of fifty miles to a place where mining processes are applied. I.R.C. § 613(c)(2); Treas. Reg. §§ 613-4(a), (f)(1). A greater distance may be allowed if the Commissioner finds that "physical and other requirements" necessitate transportation for a greater distance. Mere economic efficiency is not sufficient; the fact that the taxpayer already owns a treatment facility more than fifty miles from the extraction point will not suffice. *See* Rev. Rul. 73-557, 1973-2 C.B. 205. If a mineral is transported more than fifty miles for processing treated as mining, the first fifty miles of transportation will nevertheless remain mining transportation. Rev. Rul. 77-457, 1977-2 C.B. 207.

Transportation of fifty miles or less to a treatment plant is mining transportation only if the process treated as mining is applied by the operator at the destination. I.R.C. § 613(c)(2); Treas. Reg. § 1.613-4(f)(1)(iii)(a), (iv); Rev. Rul. 77-457, 1977-2 C.B. 207. Mining transportation does not include transportation for purposes of marketing, distribution, or delivery for the application of nonmining processes. Treas. Reg. § 1.613-4(g)(3). In the case of coal and (C) minerals, however, loading in vehicles (including railroad cars) for shipment is a mining process. I.R.C. § 613(c)(4)(A)(C); Treas. Reg. §§ 1.613-4(a), (f)(2)(i)(a). Thus, transportation to the tipple for delivery F.O.B. vehicles is mining transportation.

Transportation for processing by a purchaser or for application of a nonmining process by the operator or contractors is not mining transportation. *Rowe v. United States*, 655 F.2d 1065 (Ct. Cl. 1981); *Nicewonder v. United States*, 48 A.F.T.R. 2d (P-H) 6039 (W.D. Va. 1981). *Nicewonder* illustrates that de minimus operator activities may not constitute processing. In that case the operator delivered coal to the purchaser's tipple in the state in which it had been extracted. The purchaser required that the operator station at the breaker one of the operator's employees, whose duties included manual breaking where necessary to permit coal to pass through the screen. The court held that the employee's activity was merely assisting in unloading and that the transportation was primarily for marketing, since the coal was readily saleable in its raw state. Alternatively, the court held that even if the primary purpose of transportation was for breaking, which is a process treated as mining, the breaking was done by the purchaser, not the operator. Accordingly, the breaking was not a mining process and, therefore, the transportation was not mining transportation.

In *McClelland v. Commissioner*, 83 T.C. 958 (1984), the Tax Court held that the portion of transportation to the purchaser's tipple, for treatment that would have been mining if applied by the operator, representing bench haul could not be broken out from the overall transportation. The court rejected the taxpayer's analogy to underground mining and concluded that extraction was finished when the coal was stripped from the mine.

For a detailed discussion see Updegraft & Zychick, *Transportation of Crude Mineral Production by Mine Owners And Its Effect on Hard Minerals Depletion Allowance*, 35 Tax Law 367 (1982).

2. Extraction From Waste or Residue of Prior Mining

For purposes of percentage depletion, "mining," and thus gross income from the property, includes the extraction by a mine owner or operator of minerals from the waste or residue of the prior mining or treatment processes considered as mining. I.R.C. § 613(c)(3). However, purchaser of the waste or residue or the rights to extract minerals from the waste or residue is not entitled to percentage depletion. *Id.* The proscription of a depletion allowance deduction with respect to minerals extracted from waste or residue applies as well to purchasers who have acquired the waste or residue "merely as an incidental part of the entire mineral enterprise." Treas. Reg. § 1.613-4(i). But the transferee of a mineral property acquired in a tax free exchange from a person entitled to claim percentage depletion on minerals extracted from the waste, may claim percentage depletion; he stands in the transferor's shoes. *Id. See also Turkey Run Fuels, Inc. v. United States*, 243 F.2d 147 (3d Cir. 1957), *aff'g* 139 F. Supp. 43 (E.D. Pa. 1946) (taxable year preceding enactment of I.R.C. § 613(c)). Thus, extraction from a culm bank acquired as part of an operating mine may be subject to percentage depletion if acquired in a corporate organization; I.R.C. §§ 351, 362; corporate reorganization; I.R.C. §§ 354, 361, 362; partnership organization; I.R.C. §§ 721, 723; by gift; I.R.C. §§ 102, 1015; or by devise or inheritance; I.R.C. §§ 102, 1014. Although there is no specific authority, it would appear to also encompass like kind exchanges under I.R.C. § 1031. However, because the property takes an exchanged basis rather than transferred basis in the hands of the transferee, this may not be a theoretically correct result. Also, the presence of boot in any of the otherwise nonrecognition transactions may create a problem.

Franciosa v. United States, 231 F. Supp. 952 (E.D. Pa. 1964) denied a depletion deduction to a taxpayer who had acquired rights to extract coal from silt deposited in the bed and banks of a river as a result of up-river mining by his grantor and by others. The court reasoned that it was not clear that all of the coal and refuse was produced by mines operated by the taxpayer's grantor, and implied that a different result might be reached under I.R.C. § 613(c) if all of the refuse was from mines operated by the taxpayer's grantor. This suggestion is unwarranted; the factual distinction is irrelevant under I.R.C. § 613(c) and the regulations. No successor in interest by purchase is entitled to depletion of income derived by the extraction of coal from refuse or culm banks.

3. Miscellaneous Receipts

Various miscellaneous income items received in the course of operating a mining or oil and gas business that are not derived from production have been held to be excluded from gross income from the property for purposes of computing percentage depletion, even though the items are fully includable in gross income under I.R.C. § 61.

Income derived from providing housing, food, supplies, or services to mine employees is not included in gross income from mining. *Repplier Coal Co. v. Commissioner*, 140 F.2d 554 (3d Cir.), *cert. denied*, 323 U.S. 736 (1944); *Dorothy Glenn Coal Mining Co. v. Commissioner*, 38 B.T.A. 1154 (1938); Rev. Rul. 56-433, 1956-2 C.B. 332. Similarly, a loss incurred in such an activity does not reduce gross income from mining. Rev. Rul. 56-433, 1956-2 C.B. 332. Gains from the sale of mining equipment retired from service are not included in gross income from mining. *Monroe Coal Mining Co. v. Commissioner*, 7 T.C. 1334 (1946).

In *Roundup Coal Mining Co. v. Commissioner*, 20 T.C. 388 (1953) (*acq. and nonacq. on other issues*), the Tax Court held that the value of coal consumed on the mine premises to produce power for use in mine operations could not be included in gross income from mining. The taxpayer had included the value of the coal (based on sales prices of the coal that it marketed) in gross income and had deducted the same amount in computing taxable income. Because it concluded that the cost of the consumed coal was adequately reflected in the depletion allowance on the coal actually sold, the court disallowed the deduction. This was a minor issue in the case, the reasoning of the tax court is illogical, and *Roundup Coal* should not be followed. The result is totally inconsistent with the purpose of the percentage depletion allowance, and it cannot be reconciled with the treatment accorded integrated producers of products such as iron or steel. *Compare Alabama By-Products Corp. v. Patterson*, 258 F.2d 892 (5th Cir. 1958), *cert. denied*, 358 U.S. 930 (1959); *Woodward Iron Co. v. Patterson*, 173 F. Supp. 251 (N.D. Ala. 1959).

Guthrie v. United States, 323 F.2d 142 (6th Cir. 1963) held that proceeds of business interruption insurance were not includable in gross income in mining. On the other hand, *Amherst Coal Co. v. United States*, 295 F. Supp. 421 (S.D. W.Va. 1969), *aff'd*, 27 A.F.T.R.2d (P-H) 460 (4th Cir. 1971) (per curiam) held that damages received by a mine operator in settlement of a suit for breach of contract for failure to accept delivery of coal were includable in gross income from mining. The damages were measured by the difference between the contract price and the spot market price at which the coal was actually sold. The I.R.S. will not follow *Amherst Coal*. Rev. Rul. 77-57, 1977-1 C.B. 168 held that damages for failure to accept delivery of mineral are not includable in gross income from mining subject to depletion. The refusal of the I.R.S. to treat these damages as gross income from mining does not appear to be theoretically correct.

In Rev. Rul. 79-27, 1979-1 C.B. 217 the I.R.S. ruled that the Black Lung Excise Tax, which is separately stated on a coal sales invoice, is included in gross income from mining by the operator.

C. Computation of Gross Income From Mining Where Nonmining Transportation or Processes Have Been Applied

1. Representative Market or Field Price

The objective of the representative market or field price method of computing gross income from mining is to determine the approximate price at which the taxpayer could have sold his mineral if no nonmining transportation or nonmining processes had been applied to it. *See* Treas. Reg. § 1.613-4(c)(1).

(a) Nonmining Transportation

When no mining processes have been applied and the only nonmining transportation that has been applied is "purchased transportation to the customer," gross income from mining is the delivered sales prices (if otherwise representative of market price) minus the cost of the transportation. Treas. Reg. §§ 1.613-4(e)(2)(i); Treas. Reg. §§ 1.613-4(c)(1). "Purchased transportation to the customer" means nonmining transportation "performed solely to deliver the taxpayer's minerals . . . to the customer, rather than to transport such minerals . . . for . . . additional processing by the taxpayer . . .," that "is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer," and "with respect to which the [operator] ordinarily does not earn any profit." Treas. Reg. § 1.613-4(e)(2)(iii). If the taxpayer purchased the transportation from another person (other than a person controlled by or controlling the taxpayer), the cost of transportation is simply the amount the taxpayer paid for the transportation. The transportation costs may be separately stated or included in the delivered price. Thus, costs of shipping by common carrier may simply be deducted from the sale price. Rev. Rul. 75-115, 1975-1 C.B. 178. The representative field or market price cannot be more than the operator's delivered price less the actual cost of transportation to the customer. Treas. Reg. § 1.613-4(e)(2)(i).

If nonmining transportation, other than purchased transportation to the customer (for example transportation in excess of fifty miles for the purpose of applying mining processes and transportation to the customer in conveyances owned by the operator or leased by him) has been applied to the mineral, the operator's gross income from mining is determined with reference to the representative market or field price received by other producers selling significant quantities of minerals of like kind and grade to which no nonmining processes have been applied in the taxpayer's marketing area, reduced by the representative cost of purchased transportation to the other producers. Treas. Reg. § 1.613-4(e)(2)(i); Treas. Reg. § 1.613-4(c)(1). However, the representative market or field price so determined may not exceed the taxpayer's delivered price minus the actual cost of the nonmining transportation. Treas. Reg. § 1.613-4(e)(2)(i) (last sentence).

The same rules apply if the taxpayer earned a profit on purchased transportation to the customer, Treas. Reg. § 1.613-4(e)(2)(i), or if the purchased transportation was provided by a person controlling or controlled by the taxpayer, unless the price for such transportation was an arm's-length charge as determined under I.R.C. § 482. Treas. Reg. § 1.613-4(e)(2)(iii)(c). The taxpayer has not earned a profit on the transportation if the transportation charged the purchaser, whether separately stated or included in the sales price, is the same as the arm's length charge normally incurred by shippers of the same produce in similar circumstances. Treas. Reg. § 1.613-4(e)(2)(iii); *see also* Rev. Rul. 75-115, 1975-1 C.B. 178 (no profit earned by taxpayer on shipment by common carrier).

If the operator has applied nonmining transportation other than purchased transportation to the customer and the only representative price at which a significant quantity of minerals of like kind and grade is sold is a representative delivered price after the application of nonmining transportation to the customer, gross income from mining must be computed under the proportionate profits method since there is no representative field or market price method available.

(b) Nonmining Processes

(1) General Principles

If nonmining processes have been applied to minerals, gross income from mining must be determined under the representative market or field price method, if there is such a price. Treas. Reg. § 1.613-4(c). This method, or the proportionate profits method, see Treas. Reg. § 1.613-4(a), must be used by an integrated manufacturer, for example, a steel company that mines its own coal and iron ore, or a power utility that operates its own coal mines. *See, e.g.*, *Woodward Iron Co. v. Patterson*, 173 F. Supp. 251 (N.D. Ala. 1959) (coking coal mined by pig iron manufacturer). The regulations provide detailed general rules for computation of gross income from mining under the representative market or field price method. *See* Treas. Reg. § 1.613-4(c). The basic standard of comparison in determining representative market or field price is competitive sales of mineral of like kind and grade by the taxpayer and/or other producers in the taxpayer's marketing area. If there is a representative delivered price after purchased transportation to the customer, that price, minus a representative price of purchased transportation to the customer, (taking into account different distances and modes of transportation) is the representative field or market price. Treas. Reg. § 1.613-4(4)(2)(i).

Section 1.613-4(c)(3) of the Treasury Regulations specifies numerous factors to be considered in determining representative market or field prices. The prime factor is a weighted average of the competitive selling prices in the relevant market of mineral of like kind and grade to which no nonmining processes have been applied. This rule will be applied even though the market sales are at a price that is not profitable. Only sales under normal conditions should be considered. *Kaiser Steel Corp. v. United States*, 411 F.2d 335 (9th Cir. 1969). Sales prices between members of a controlled group will be deemed to be competitive where the Commissioner has exercised his power under I.R.C. § 482 to reallocate income between controlled taxpayers. Treas. Reg. 1.612-4(c). The identity of the relevant market and the representative market or field price within that market are factual determinations. Treas. Reg. § 1.612-4(c)(3); *see Kaiser Steel*, 411 F.2d 335.

If the sum of the taxpayer's cost of applying nonmining processes and transportation and an asserted representative field or market price regularly results in a loss on sale of the taxpayer's finished product, however, the asserted representative field or market price will be presumed to be too high. Treas. Reg. § 1.613-4(c)(6); Rev. Rul. 77-296, 1977-2 C.B. 207; Rev. Rul. 77-

33, 1977-1 C.B. 165. The regulations provide the following example:

> [I]f on a regular basis the total of all costs of nonmining processes applied by the taxpayer to coal for the purposes of making coke is $12 per ton and if the taxpayer's actual sale price for such coke is $18 per ton, a price of $7 per ton would not be a representative market or field price for the taxpayer's coal which is used for making coke.

Treas. Reg. § 1.613-4(c)(6). The presumption can be rebutted by establishing that the loss on nonmining operations is due to unusual nonrecurring factors, such as fire, flood, earthquake, explosion, or strike. Treas. Reg. § 1.613-4(c)(6).

In *Bloomington Limestone Corp. v. United States*, 445 F.2d 1105 (7th Cir. 1971) the Seventh Circuit held that the factors in the regulations were not exclusive and the presumption was not raised where in eighteen years the taxpayer showed consistent profits from mining but only had six intermittent profitable years from its finished operations. In *Gray Knox Marble Co. v. United States*, 257 F. Supp. 632 (E.D. Tenn. 1966), the court applied the presumption where the taxpayer showed mining profits for eight consecutive years but consistently large manufacturing losses for those years.

(2) Minerals of "Like Kind and Grade"

Section 1.613-4(c)(2) of the Treasury Regulations provides that minerals are of "like kind and grade"

> "if in common commercial practice it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's . . . mineral that is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayer's . . . mineral is put." However, "the fact that taxpayer's . . . mineral is suitable for the same general commercial use as another person's . . . mineral will not cause the two . . . minerals to be considered to be of like kind and grade if the desirable natural constituents of the two . . . minerals are markedly different substances."

The regulations specifically provide that anthracite coal and bituminous coal are not like kind and that bituminous coal without coking qualities is not of like kind with bituminous coal with coking qualities. But if the taxpayer mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered of like kind, and all bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer. The standards to be applied to determine like kind and grade of coal are discussed extensively in *Alabama By-Products Corp. v. Patterson*, 258 F.2d 892 (5th Cir. 1958), *cert. denied*, 358 U.S. 930 (1959); *Woodward Iron Co. v. Patterson*, 173 F. Supp. 251 (N.D. Ala. 1959); *Kaiser Steel Corp. v. United States*, 411 F.2d 335 (9th Cir. 1969).

If there is no representative market or field price for minerals of like kind and grade as taxpayer's minerals, but there is a representative market or field price for minerals of like kind, but not grade, then the representative market or field price of the like kind minerals will be used, with appropriate adjustments, if such adjustments may be readily ascertainable. Treas. Reg. § 1.613-4(c)(4).

2. Proportionate Profits and Alternative Methods

If it is impossible to determine a representative field or market price, gross income from mining will be computed under the proportionate profits method, unless the use of an alternative method is more appropriate than the proportionate profits method. Treas. Reg. § 1.613-4(d)(1). If an alternative method is more appropriate, it can be required at the initiative of the I.R.S. or upon application by the taxpayer to the I.R.S. Treas. Reg. § 1.613-4(d)(1)(ii)(a). For the procedures to obtain approval *see* Rev. Proc. 74-43, 1974-2 C.B. 496. For possible alternative methods see Treas. Reg. § 1.613-4(d)(5) - 4(d)(7). The regulations apply the proportionate profits method only to gross income from mining; there is no authority for applying this method to oil and gas properties. If a representative market or field price can be determined, neither the proportionate profits method nor any alternative method may be used.

The proportionate profits method determines gross income from mining on the principle that each dollar of the total cost to produce and sell the first marketable product earns the same percentage of profit. Treas. Reg. § 1.613-4(d)(4). The regulations prescribe the following formula to determine gross income from mining:

$$(\text{Mining Costs} \div \text{Total Costs}) \times \text{Gross Sales} = \text{Gross Income From Mining}$$

"Gross sales" are the taxpayer's aggregate competitive sales of his first marketable product, Treas. Reg. § 1.613-4(d)(4)(v)(a), reduced by trade and cash discounts, Treas. Reg. § 1.613-4(e)(1), and the cost of purchased transportation for delivery to customers. Treas. Reg. § 613-4(e)(2)(ii). If the taxpayer applies additional manufacturing processes to the first marketable product, then the actual sales price of the taxpayer's actual product is not used. Gross sales are determined by reference to a "constructive sale" price for that portion of the first marketable product used or retained for the taxpayer's operations. Treas. Reg. § 1.613-4(d)(4)(v)(a); *see, e.g.*, *Standard Lime & Cement Co. v. United States*, 329 F.2d 939 (Ct. Cl. 1964); *United States v. Claycraft Co.*, 364 F. Supp. 1358 (S.D. Ohio 1972). The dollar value of constructive sales is determined under the principles of the representative market or field price method. Treas. Reg. § 1.613-4(d)(4)(v)(a).

The regulations define the first marketable product as the "product . . . produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area." Treas. Reg. § 1.613-4(d)(4)(iv). The first marketable product does not include any product resulting from additional manufacturing or other nonmining processes applied to the product first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area.

For example, if the taxpayer were an integrated steel producer and in the taxpayer's marketing area all coal was consumed by either integrated steel producers or coke producers, there might be no representative market or field price for coal. However, if coke was sold in significant quantities by other manufacturers in the taxpayer's marketing area, then coke and not steel would be the taxpayer's first marketable product. This would be true even if the taxpayer itself sold only steel. Accordingly, the taxpayer's gross sales under the proportionate profits method would be the constructive sales price of the coke consumed in the manufacture of the steel. This price would be determined by applying the principles of the representative field or market price methods to sales of coke in the taxpayer's marketing area.

In determining the cost inputs, the numerator of the fraction is "the sum of all the costs allocable to those mining processes which are applied to produce, sell and transport the first marketable product"; the denominator is "the total of all the mining and nonmining costs paid or incurred to produce, sell and transport the first marketable product." Treas. Reg. § 1.613-4(d)(4)(ii).

Direct costs attributable to manufacturing applied after the first marketable product has been produced are not taken into account in the computation. *North Carolina Granite Corp. v. Commissioner*, 56 T.C. 1281 (1971), *acq. clarified*, Rev. Rul. 77-179, 1977-1 C.B. 168. Cash and trade discounts, which are excluded from gross sales, are also excluded from the denominator of the fraction. Treas. Reg. § 1.613-4(e)(1). The same rule applies to the cost of purchased transportation to the customer if the taxpayer makes no profit on the transportation. This does not exclude purchased nonmining transportation relating to shipment for additional nonmining processing necessary to produce the taxpayer's first marketable product. Treas. Reg. § 1.613-4(e)(2)(iii)(b); Rev. Rul. 75-115, 1975-1 C.B. 178. The purpose of this exclusion is to prevent the allocation of any profits to purchased transportation.

Costs that are directly allocable to mining, including treatment processes considered as mining under I.R.C. § 163(c)(4) and mining transportation, are allocated to the numerator. Costs which are directly allocable to nonmining processes, including nonmining transportation, are excluded from the numerator. Only actual costs may be included in either the numerator or denominator. Generally, the amount of any item to be included as a cost is the amount for purposes of computing the taxpayer's federal income tax, including depreciation and cost recovery. Treas. Reg. § 1.613-4(d)(2). No ranking of costs that results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product is permitted. Treas. Reg. § 1.612-4(d)(4)(i).

A reasonable portion of the selling expenses of a manufactured product may be allocated to mining costs. Treas. Reg. §§ 1.613-4(d)(3)(iv), -5(c)(4)(ii). A "reasonable portion" is the "typical selling expenses which are incurred by unintegrated miners or producers." *Id.* Selling expenses are broadly defined in the regulations, including salaries, commissions and other direct costs, as well as overhead attributable to sales personnel. Treas. Reg. § 1.613-5(c)(4)(iii). All costs incurred to produce, sell and transport the first marketable product that cannot be directly attributed to a particular mining process or nonmining process must be apportioned between mining and nonmining costs by a method which is "reasonable under the circumstances." Treas. Reg. § 1.613-4(d)(4)(iii). The regulations provide some guidance. Additionally, the principles used to allocate indirect costs in determining taxable income from the property for purposes of applying the "fifty percent of the taxable income from the property limitation" may be helpful in arriving at a reasonable allocation under the proportionate profits method.

D. *Fifty Percent of Taxable Income From the Property*

Percentage depletion for both solid minerals and oil and gas is limited to fifty percent of the taxable income from the property. I.R.C. § 613(a). Cost depletion is not subject to any such limitation. I.R.C. § 611. For oil and gas, I.R.C. § 613A(d) imposes an additional limitation based on overall taxable income, taking all sources into account. *See supra* Part I.B.3.(b). The fifty percent limitation applicable to both solid minerals and oil and gas, on the other hand, is based solely on taxable income from the extraction of minerals and is computed on a property-by-property basis (determined under I.R.C. section 614). The regulations define taxable income from the property as follows:

> The term taxable income from the property . . . means gross income from the property . . ., less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administra-

> tive and financial overhead, depreciation, taxes deductible under section 162 or section 164, losses sustained, . . . exploration and development expenditures, etc. . . . . Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly apportioned to the mineral property and to such other activities. Furthermore, where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the several properties. . . .

Treas. Reg. § 1.613-5(a).

Because the starting point for computing taxable income from the property is gross income from the property, rents and royalties paid by a lessee are excluded from the computation, and are not deducted. Deducting rents and royalties would take them into account twice. For a lessor, taxable income from the property generally equals gross income from the property, unless the lessor has expenses attributable to the lease in a particular year. This rule applies to net profits royalties as well as to fractional royalties.

The term "operating expenses" in this regulation include all expenses charged to cost of goods sold under an inventory accounting method, other than any portion of the cost basis of the mineral deposit. Thus, expenses capitalized under I.R.C. § 263A with respect to the extraction of minerals, and the application of mining processes to those minerals, are deducted in computing taxable income from the property. These items should be deducted, however, in the year properly taken into account in cost of goods sold under the taxpayer's inventory method, not in the year paid or accrued. Other capital expenses, such as the cost of equipment and structures associated with the extraction are not deducted currently, but ACRS deductions attributable to such operating assets are taken into account in the year that they are deductible in computing taxable income generally. Rev. Rul. 83-134, 1983-2 C.B. 103 requires that taxable income from the property be determined using tax accounting costs, not book accounting costs. Thus, ACRS claimed for tax purposes, and not the lesser book depreciation, on property used in production (or attributed to overhead) must be used in computing the ceiling on percentage depletion.

Deductible expenses that relate to both mineral production and nonproduction activities must be apportioned between the two activities, and only the portion allocated to production must be subtracted. Treas. Reg. § 1.613-5(a). If an expense item relates to two or more properties, it must be allocated among the properties to which it relates, because the depletion deduction is separately computed for each property. Treas. Reg. § 1.613-5(c)(4)(iii).

The treatment of a number of items should be specifically noted.

1. Lease Bonus Payments

Because taxable income from the property is computed with reference to "gross income from the property" and not gross income under I.R.C. § 61, lease bonus payments must be deducted in the year to which they are attributable even though they are not deductible in computing taxable income under I.R.C. § 63. *See* Treas. Reg. § 1.613-2(c)(5)(ii); Rev. Rul. 79-73, 1979-1 C.B. 218.

2. Selling Expenses

Selling expenses must be subtracted from gross income from the property in computing taxable income property. Treas. Reg. § 1.613-5(c)(4)(i). Because the fifty percent of taxable income limitation is computed on a property-by-property basis, selling expenses which benefit more than one property must be apportioned between the properties. Treas. Reg. § 1.613-5(a); *Occidental Petroleum Co. v. Commissioner*, 55 T.C. 115 (1970), (*acq.*). If the taxpayer is an integrated manufacturer, only an amount equal to the typical selling expenses incurred by unintegrated miners must be subtracted; if integrated miners typically incur no selling expenses, no deduction is necessary. Treas. Reg. § 1.613-5(c)(4)(ii). Selling expenses include sales management salaries, rent of sales offices, clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, including an allocable share of overhead for supporting services, but not delivery costs. Treas. Reg. § 1.613-5(c)(4)(iv).

3. Trade Association Dues

All or a portion of trade association dues may be deductible in computing taxable income from the property. *See* Treas. Reg. § 1.613-5(c)(6).

4. Wages and Pension Fund Contributions

Both wages and pension fund contributions for employees attributable to mining or oil and gas production are deductible. *Occidental Petroleum Co. v. Commissioner*, 55 T.C. 115 (1970) (acq.). Guaranteed payments to a partner deductible under I.R.C. § 707, however, are not deductible in computing the percentage depletion ceiling. *Mallary v. United States*, 238 F. Supp. 87 (M.D. Ga. 1965).

5. Taxes

Taxes deductible under I.R.C. § 162 or I.R.C. § 164 are deducted to the extent allocable to mining or oil and gas production. Thus, severance taxes, state income and franchise taxes, federal social security and unemployment taxes, and state and local real and personal *ad valorem* property taxes must be deducted. *Montreal Mining Co. v. Commissioner*, 2 T.C. 688 (1946), *aff'd*, 33 A.F.T.R.2d (P-H) 1660 (6th Cir. 1944). Taxes capitalized under I.R.C. § 266 should not be deducted. Treas. Reg. § 1.613-5(c)(5). Similarly, taxes capitalized under I.R.C. § 263A are not deducted in the year paid, but enter into the deduction for operating expenses in the year properly deducted as inventory costs. *Ad valorem* property taxes paid by a lessee on behalf of a lessor that are excluded from the lessee's gross income from the property as royalties are not deducted.

6. Interest

Interest incurred in a mining or an oil and gas operation is deductible, whether incurred to obtain funds for development, to purchase equipment, to purchase the mineral property, or to provide operating capital. *Guanacevi Mining Co. v. Commissioner*, 127 F.2d 49 (9th Cir. 1942), *aff'g* 43 B.T.A. 517 (1941) (development expenses); *St. Mary's Oil & Gas Co. v. Commissioner*, 42 B.T.A. 270 (1940) (mineral property purchase money); *Central State Collieries, Inc. v. Commissioner*, 10 B.T.A.M. (P-H) ¶ 41,251 (1941) (equipment); *Lumaghi Coal Co. v. Commissioner*, 124 F.2d 645 (8th Cir. 1942). This includes interest on corporate bonds, discounts in issuance of bonds, premiums on redemption of bonds, and amortizable costs of issuing the bonds. *Sheridan-Wyoming Coal Co. v. Helvering*, 125 F.2d 42 (D.C. Cir. 1941); *St. Louis Rocky Mountain & Pacific Co. v. Commissioner*, 28 T.C. 28 (1957). Interest on corporate bonds must be allocated between mining or oil and gas production activities and nonproduction activities (i.e., manufacturing or nonmining processes) and then between separate mining or oil and gas properties. *St. Louis Rocky Mountain*, 28 T.C. 28. For a corporation, interest on a federal income tax deficiency is deducted if the deficiency relates to income from mining or oil and gas production. *Holly Development Co. v. Commissioner*, 44 B.T.A. 51 (1941). If, however, the deficiency results from an adjustment to any item that must be allocated between production and nonproduction activities, then only a portion of the interest on the deficiency will be deducted. For individuals, however, in taxable years after 1986 interest on a tax deficiency is not deductible by reason of I.R.C. § 163(h), subject to transition rules for 1987-1990. Since this interest is not deductible in computing taxable income under I.R.C. § 63, it should not be deducted in computing taxable income from the property.

The purpose for which interest is paid, either by individuals (including partnerships) or corporations, presumably is determined under the interest tracing rules of Temp. Reg. § 1.163-8T. When the taxpayer has more than one property, interest not directly attributable to a particular property must be fairly apportioned between them. *See* Gen. Couns. Mem. 22,956, 1941-2 C.B. 103. The interest tracing regulations must be considered in making any apportionment.

Interest should be taken into account in the year that it is deductible under I.R.C. § 163. Thus, interest on a loan incurred to acquire a nonoperating interest (for example, an overriding royalty), which may be subject to deferral under I.R.C. § 163(d), will be taken into account only in the year in which it is deductible under that provision. Interest that is deferred under the passive loss rules of I.R.C. § 469, however, probably should be taken into account using the taxpayer's normal accounting method, notwithstanding that a portion is deferred under I.R.C. § 469.

Finally, interest expense may be offset by interest income. *General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980); *cert. denied*, 450 U.S. 983 (1981); *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352 (1984).

7. Recession of Working Face Expenses

Expenditures for equipment necessary to maintain normal output solely because of recession of the working face of the mine that qualify under Treas. Reg. § 1.612-2(a) for deduction as ordinary and necessary business expenses must be deducted in computing taxable income from the property. *Commissioner v. Harman Coal Corp.*, 200 F.2d 415 (4th Cir. 1952).

8. Net Operating Loss Carryovers

Net operating loss carryovers under I.R.C. § 172 are not deducted. Rev. Rul. 60-164, 1960-1 C.B. 254.

9. Depreciation and ACRS Deductions

Depreciation and ACRS deductions are apportioned between production and nonproduction activities and between properties if the depreciable property is used to directly benefit more than one property; hours of use is a reasonable meathod of apportionment. *See* Treas. Reg. § 1.613-4(b)(7) (Exs. 1, 2). Like other operating expenses (except interest) depreciation is subject to capitalization under I.R.C. § 263A, and thus generally is taken into account as an inventory cost.

Under I.R.C. § 168(g) the taxpayer may elect to recover the cost of property under the alternative depreciation system rather than at the statutory accelerated rate. Electing to use the alternative depreciation system may increase aggregate percentage depletion deductions allowable when the fifty percent of taxable income limit has an effect.

The cost of maximizing aggregate depletion deductions is deferral of ACRS deductions, however, and a time value of money analysis specific to the facts of each property is necessary. In most cases, such an election will not be beneficial. The same issue arises with the election to expense capital costs under I.R.C. § 179.

To avoid ACRS deductions reducing the allowable depletion deduction, the preferable route is to incorporate a separate leasing corporation (or partnership), and to lease the equipment at an arm's length rental to the operating corporation. The rental expenses may be significantly less than the combined ACRS and interest deductions. The leasing corporation's net operating loss and the operating corporation's taxable income, after a full allowance for depletion, can then be combined on a consolidated return under I.R.C. §§ 1501-1505.

10. Solid Mineral Exploration and Development Expense

Exploration and development expenses are taken into account in computing taxable income from the property in the year in which they are deducted under I.R.C. § 617 or I.R.C. § 616. Treas. Reg. § 1.613-5(c)(2). (These expenses are not subject to I.R.C. § 263A). Because an election to defer development expenses deductions during the development stage applies only to the excess of development expenses over net receipts from the mine, an election to defer the deduction cannot be used to accelerate the year in which the depletion deduction may be taken by raising the taxable income ceiling in the year the expense is incurred with the concomitant reduction in a future year in which the expenses are deducted. However, since net operating loss carryovers are not considered in computing taxable income from the property, a taxpayer who does not elect to defer excess development expenses may receive the benefit of the deduction under I.R.C. § 63 in the year to which the net operating loss is carried. The taxpayer does not suffer the burden of reducing the fifty percent of taxable income limitation depletion in that year.

Development expenses incurred during the production stage of the mine, however, may be deferred without regard to the net receipts from the mine. It frequently may be advisable to defer development expenses and spread the deduction out to avoid a reduction in the percentage depletion allowance effected by a large development expense deduction in the year the expense is incurred.

Spreading the deduction over the life of the mine may maximize aggregate allowable depletion deductions, but it will also increase taxable income under I.R.C. § 63 for the year in which the expense was incurred relative to the taxable income that would have been computed had development expense deductions not been deferred. Therefore, the analysis must include a time value of money factor.

If exploration expenses deductible under I.R.C. § 617(a)(1) have all been deducted in a taxable year prior to the first production and the operator elects to recapture the deducted exploration expenses under the method specified in I.R.C. § 617(b)(1), taxable income under I.R.C. § 63 for the year of the election is increased by the amount of the previously deducted exploration expenditures, but gross income from the property, i.e. the starting point for computing taxable income from the property, is not affected. Treas. Reg. § 1.617-3(a)(2). If, alternatively, the operator recaptures the previously deducted exploration expenses under I.R.C. § 617(b)(1)(B) recapture may be spread over two or more years, but the effect on income is the same. Aggregate taxable income over the recapture period is increased by the amount of the previously deducted exploration expenditures. This is advantageous, however, due to the deferral factor.

11. Mine Reclamation and Closing Costs

Additions to a reserve for mine closing and reclamation costs deducted under I.R.C. § 468 should be deducted in computing the fifty percent of taxable income from the property ceiling under the general rule of Treas. Reg. § 1.613-4(a). For I.R.C. § 468, see Part VIII.B.2, *infra*. There is no authority in either the statute or regulations for offsetting reclamation and closing reserve recapture income under I.R.C. §§ 468(a)(4)(A) and (5) to reduce other deductions in computing the ceiling. *Compare with* "Offset of Section 1245 Recapture Income," *infra*. It would be theoretically proper to increase taxable income from mining by any recapture income attributable to prior deductions. It would not be so clearly proper with respect to deemed interest accruals under I.R.C. § 468(a)(2)(B)(i), since interest income is not gross income from mining.

12. Offset of Section 1245 Recapture Income

Although profits from the sale of mining equipment are not included in gross income from mining, the sum of the deductions that are taken into account in computing taxable income from mining is reduced by any income from the sale of property treated as ordinary income under I.R.C. § 1245 that is properly allocable to the property. Thus, the ceiling on the depletion allowance is increased by the amount of recapture income. I.R.C. § 613(a); Treas. Reg. § 1.613-5(b). In addition to recapture on mining equipment, I.R.C. § 1245 recapture includes recapture on mining real property improvements, the cost of which has been recovered under ACRS at the statutory accelerated rate (with respect to property placed in service before January 1, 1987), deductions claimed under I.R.C. § 179, and the basis reduction required by I.R.C. § 48(q) with respect to the Investment Tax Credit under I.R.C. § 46 (with respect to property eligible for the ITC).

The determination of the amount of recapture income allocable to a specific mineral property can be complex. The regulations are detailed and include numerous examples. *See* Treas. Reg. § 1.613-5(b). Absent aggregation of mineral properties, the basic rule is that the portion of recapture gain allocable to a specific mineral property is that portion of the total recapture gain that bears the same ratio to the total recapture gain as the depreciation or cost recovery deductions taken for the depreciable asset and previously deducted from gross income from mining in a prior year, which would have been taken into account if percentage depletion had been claimed in the prior year, bears to the total depreciation or cost recovery allowed with respect to the depreciable asset. If the asset was used to benefit different properties in different years, the recapture income is allocated between the properties in the same ratio that deductions originally taken were allocated. The regulations provide specific rules dealing with property that was used partly in mining activity and partly in nonmining activity and recapture property used in connection with more than one mining property or in connection with aggregated or disaggregated properties.

Although it would seem to be logically warranted, there is no statutory authority for offsetting any gain recognized on the sale of property that has been expensed under the recession of the working face doctrine embodied in Treas. Reg. § 1.612-2(a). *See Island Creek Coal Co. v. Commissioner*, 30 T.C. 370 (1958). (Sale of scrap items, including steel and wire, does not offset deductions). *But see Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352, 402 (1984) (allowing offset of interest income against interest expense, and distinguishing *Island Creek Coal* as involving a separate scrap or salvage business).

The fifty percent of taxable income ceiling on depletion for oil and gas is *not* increased by I.R.C. § 1245 recapture income. *See* Internal Revenue Manual § 362.5. Under express statutory language, the offset of recapture income applies only to mining.

13. Overhead and Other Indirect Costs

A portion of overhead and indirect costs must be allocated to production activities. Proper allocation of overhead and indirect costs between production and nonproduction activities and among properties is primarily an accounting problem. Nevertheless, the standard for allocating such expenses is based on a "fair" apportionment, not a "clear reflection of income" standard analogous to I.R.C. § 446(b). Accordingly, the Commissioner does not have his powers under I.R.C. § 446(b) available to him in cases involving the determination under Treas. Reg. § 1.613-5. *See Occidental Petroleum Co. v. Commissioner*, 55 T.C. 115 (1970) (*acq.*).

The leading case dealing with the apportionment of indirect costs among mines is *Occidental Petroleum Co.*, in which indirect costs were allocated relative to direct costs, and direct costs, such as selling expenses and UMW pension plan payments, with respect to employees working away from the mine, were allocated according to tonnage. Other methods for particular items may be reasonable on the particular facts. Indirect supervisory personnel expenses could be allocated based on time expended for each separate property, while workman's compensation and mine safety expenses probably should be allocated on the basis of accident records and time actually expended. Depreciation and interest would be better allocated based upon the respective investment in each separate property. This final category needs even further refinement. For example, interest and depreciation on general administrative offices seem to be better allocated relative to direct costs, while general bond interest might be better allocated relative to investment. But in *Shell Oil Co. v. Commissioner*, 89 T.C. 371 (1987), the Tax Court treated interest as general overhead.

Indirect costs must also be apportioned between mining and nonmining activities and only that portion attributable to mining must be deducted. Treas. Reg. § 1.613-5(a). In *Tennessee Consolidated Coal Co. v. Commissioner*, 15 T.C. 424 (1950), the Tax Court rejected the Commissioner's argument that indirect costs should be universally allocated between mining and nonmining activities in proportion to direct costs. Instead, based on evidence presented by the taxpayer, the court approved allocation to mining of varying percentages of the deductible expenses.

Shell Oil Co., *supra*, held that dry hole costs and exploration costs are not overhead, but are attributable only to the nonproducing or abandoned properties with respect to which they were incurred. Selling expenses and transportation are allocated in the manner described in Part VII. C. 2, *supra*, for apportioning costs under the proportionate profits method.

14. Production Payments

If a production payment was retained by the payee in a transaction involving the sale of a mineral property to the operator, the production payment is treated as a purchase money mortgage loan. I.R.C. § 636(b). The entire amount of the production payment is included in the payor's gross income from the property. The portion of each payment representing interest is deducted from property gross income in computing property's taxable income. In determining the allocation of interest, the provisions of I.R.C. §§ 1272-74 and I.R.C. § 483 are applicable, and if inadequate interest is stated, interest will be imputed. Treas. Reg. § 1.636-1(a)(ii). The operating expenses attributable to the production payment are deductible in computing taxable income from the property. Rev. Rul. 71-35, 1971-1 C.B. 51.

A production payment retained by a lessor is treated by the lessee as a lease bonus payable in installments, I.R.C. § 636(c). Payments are excluded from gross income from the property in full, and are not taken into account again in computing taxable income from the property.

A production payment carved out to finance exploration or development transfers an economic interest in the property I.R.C.

§ 636(a). Therefore, it reduces the operator's gross income from the property. However, the operator may not claim any deductions for development expenses paid from the proceeds of the sale of the production payment, or IDC and depreciation (ACRS) if the proceeds are used to drill an oil well. *Anderson v. Commissioner*, 466 F.2d 672 (8th Cir. 1971). In Rev. Rul. 74-549, 1974-2 C.B. 186, the Internal Revenue Service ruled that a carved out production payment, the proceeds of which were used to purchase equipment and finance the removal of overburden, was to be treated as a loan and not as a production payment under I.R.C. § 636(a).

VIII. UNIQUE OPERATING DEDUCTIONS

A. *Recession of the Working Face Doctrine*

1. Generally

Section 1.612-2(a) of the Treasury Regulations provides for the current deduction of certain expenditures that would otherwise be treated as capital expenditures, and/or separately capitalized as a depreciable asset, the cost of which would be recovered through depreciation under I.R.C. § 167 or ACRS under I.R.C. § 168. Treas. Reg. § 1.612-2(a) provides:

> (a) In general — Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which —
>
> (1) Do not increase the value of the mine, or
>
> (2) Do not decrease the cost of production of mineral units, or
>
> (3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is, or has been made shall be deducted as ordinary and necessary business expenses.

Whether expenditures must be capitalized or may be deducted under Treas. Reg. § 1.612-2(a) depends on the particular facts of the case. One key factor is whether the mine is already operating at full capacity. *Compare New Pittsburgh Coal Co. v. United States*, 200 F.2d 146 (6th Cir. 1952), *with Enterprise Coal Co. v. Phillips*, 12 F. Supp. 49 (M.D. Pa. 1935), *aff'd* 84 F.2d 565 (3d Cir. 1935) (deduction denied where taxpayer failed to prove that mine had reached complete development).

2. Items Subject to Election

Among the items for which deductions have been allowed are:

(1) Additional rails, mine cars, switches and trolley wires, needed *after* mine had reached maximum capacity. *Commissioner v. Brier Hill Collieries*, 50 F.2d 777 (6th Cir. 1931).

(2) Electric locomotive, mine cars and rails. *Marsh Fork Coal Co. v. Lucas*, 42 F.2d 83 (4th Cir. 1930).

(3) Airshaft, fan and compressor to provide ventilation at mine face. *Roundup Coal Mining Corp. v. Commissioner*, 20 T.C. 388 (1953) (*non acq.*).

(4) Power lines, substations, and transformers. *Amherst Coal Co. v. United States*, 240 F. Supp. 977 (S.D. W.Va. 1965), (*aff'd*, 27 A.F.T.R.2d 460 (4th Cir. 1971) (per curiam).

(5) Conveyors. *Adkins v. Commissioner*, 51 T.C. 957 (1969).

Costs of equipment to increase the efficiency of a mine, however, are not deductible under the recession of the working face doctrine, *United States Gypsum Co. v. United States*, 206 F. Supp. 744 (N.D. Ill. 1962) (additional shovel), even if necessitated by a change in the thickness of a coal seam as the face recedes. *Commmissioner v. Harmon Coal Corp.*, 200 F.2d 415 (4th Cir. 1952), *rev'g* 16 T.C. 787 (1951) (miners' equipment). *But see W.M. Ritter Lumber Co. v. Commissioner*, 30 B.T.A. 231 (1934). Nor are expenses for equipment not placed in service during the year currently deductible. *Roundup Coal Mining Corp. v. Commissioner*, 20 T.C. 388 (1953); *Beech Creek Coal Co. v. Lucas*, 15 A.F.T.R. (P-H) 508 (W.D. Ky. 1926).

3. Effect

Claiming deductions under the recession of the working face doctrine instead of capitalizing the expense and recovering the cost through depreciation deductions is highly advantageous and necessary to clearly reflect income. From 1981 through 1986 the relative benefit of the recession of the working face doctrine was greatly reduced because the combined benefits of the Investment Tax Credit and ACRS on five-year recovery property were functionally equivalent to an immediate deduction. With the repeal of the Investment Tax Credit and the extension of the cost recovery periods for depreciable tangible personal property in the Tax Reform Act of 1986, the recession of the working face doctrine again provides a significant tax benefit. It is highly preferable to unit of production depreciation, under Treas. Reg. §§ 1.167(b)-0(b) and 1.611-5(b)(2), which is still permitted under I.R.C. § 168(f)(1).

B. *Mine Reclamation and Closing Expenses*

1. Before The Tax Reform Act of 1984

A number of early cases had denied accrual basis taxpayers a current deduction for estimated costs of reclamation of surface mines on the grounds that the estimates were not reasonable. *See, e.g., Commissioner v. Gregory Run Coal Co.*, 212 F.2d 52 (4th Cir.), *cert. denied*, 348 U.S. 828 (1954); *Patsch v. Commissioner*, 19 T.C. 189 (1952), *aff'd*, 208 F.2d 532 (3d Cir. 1953). In *Denise Coal Co. v. Commissioner*, 29 T.C. 528 (1957), *aff'd in part, rev'd in part*, 271 F.2d 930 (3d Cir. 1959), the Tax Court denied a deduction for accrued estimates of future reclamation expenses because the taxpayer had neither restored the surface itself nor entered into a contract with a third party giving rise to an obligation to pay. A similar result was reached by the Tax Court in *Harrold v. Commissioner*, 192 F.2d 1002 (4th Cir. 1951), *rev'g* 16 T.C. 134 (1951). The Court of Appeals, however, reversed *Harrold*, finding the accrual of a reserve to be proper. Subsequently, in *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 369 (1981), the Tax Court reversed the position it took in *Denise Coal Co.* and *Harrold v. Commissioner*, and adopted the view of the Courts of Appeal allowing the current accrual of a deduction for future reclamation costs. This line of cases had no effect on cash basis taxpayers. Unlike accrual basis taxpayers, cash basis taxpayers could deduct surface mine reclamation expenses only in the year of payment.

2. I.R.C. Section 468 Reserve Accounting

In the Tax Reform Act of 1984, Congress enacted I.R.C. § 468, which, at the election of the taxpayer, governs the timing of deductions for mine reclamation and closing costs.

(a) Deduction for Additions to Reserve

Under I.R.C. § 468, both cash and accrual basis taxpayers may elect, on a property-by-property basis (using property as defined in I.R.C. § 614), to take a current deduction for the current qualified reclamation costs allocable to the portion of the mineral property "disturbed" during the year and the current qualified closing costs allocable to the production during the year, using the unit of production method. I.R.C. §§ 468(a)(1), 469(d)(1)(B)(ii)(I). "Current reclamation costs" and "current closing costs" are the amount that the taxpayers would be required to pay if the costs were incurred currently. I.R.C. § 468(d)(1). "Qualified" costs are expenses incurred for reclamation or closing pursuant to a reclamation plan which is part of a permit under the Surface Mining Control and Reclamation Act 30 U.S.C. §§ 1201-1328 (1982), or pursuant to any other Federal or State law with substantially similar requirements. I.R.C. § 468(d)(2)(A).

(b) Adjustments to Reserve

Amounts deducted as qualified closing costs or qualified reclamation costs are added to reserve accounts for each purpose. These accounts must be maintained on a property-by-property basis. Each year the amount of the reserve account must be increased by an amount equal to the Federal short term rate under I.R.C. § 1274, compounded semi-annually. I.R.C. § 468(a)(2)(B)(i). (For 1984 and 1985 the applicable interest rate was only 70 percent of the Federal short term rate, and for 1986 the applicable rate was only 85 percent of the Federal short term rate. I.R.C. § 468(a)(2)(B)(ii)). The Federal short term rate is determined monthly and published in a Revenue Ruling.

(c) Treatment of Expenses at Time of Payment

Payments for qualified mine closing and reclamation costs are charged to the reserve rather than deducted. I.R.C. § 468(a)(2)(C).

Payments in excess of the closing balance of the reserve at the end of the year, after the interest adjustment, but before charging any expenses, may be deducted in the year paid. I.R.C. § 468(a)(3).

(d) Recapture of Additions to Reserve

If at the end of any year the balance of any mine closing or reclamation reserve account, after all adjustments, exceeds the current mine closing costs or reclamation costs, determined as if all production had occurred in that year (i.e., the estimated cost of currently reclaiming all disturbed land or closing the mine), the excess must be currently included in income. I.R.C. § 468(a)(4). Operation of the recapture rule was illustrated in House Report 98-861, 98th Cong., 2d Sess. 881-82 (1984) as follows:

> The balance of the site reclamation sinking fund, at the end of each tax year, is limited to the current cost of reclaiming land that has been disturbed, subsequent to the date of election, but not previously reclaimed. For example, if at the end of the first tax year after site opening, 20 acres have been disturbed and the per acre cost of reclamation is $10, then $200 (20 x $10) may be deducted in that year and the sinking fund balance is limited to the same amount. If at the end of the second tax year 20 additional acres are disturbed, the per acre cost of reclamation has risen to $11, and no reclamation work has been paid for, then $220 (20 x $11) may be deducted in that year and the sinking fund balance is limited to $440 (40 x $11).

The balance of the site closing sinking fund, at the end of each tax year, is limited to the current cost of closing the portion of the site which has been utilized (based on a units of production or capacity method), subsequent to the date of election. For example, suppose that site capacity is 500 units, 100 units are produced (or utilized) at the end of the first year, and the current cost of closing the entire site is $1,000. In this case, $200 ($1,000 x 100/500) may be deducted in that year and the sinking fund balance is limited to the same amount. If at the end of the second tax year an additional 100 units are produced and the current cost of site closing has risen to $1,100, then $225 may be deducted (i.e., the unrecovered cost of current site closing ($1,100-$200) times the proportion of remaining units produced during the tax year 100/(500-100)) and the fund balance is limited to $440 ($1,100 x 200/500)).

Section 468(a)(5) provides for recapture of the balance of the reserve upon the revocation of an election, completion of the closing (after charging the costs to the reserve), or the "disposition" of the property. If the taxpayer disposes of only a portion of the property, only the portion of the reserve attributable to that portion of the reserve will be recaptured.

(e) Effect of Failure to Elect

Absent an election under I.R.C. § 468 to apply the reserve accounting rules, I.R.C. § 461(h) requires that deductions for mine reclamation costs or mine closing costs be deferred until the year of economic performance. Economic performance occurs in the year in which either the taxpayer or a third party actually performs the services. I.R.C. §§ 461(h)(2)(A), (h)(2)(B). Thus, for years after the effective date of I.R.C. § 461(h) and I.R.C. § 468, *Ohio River Collieries*, *supra*, has been legislatively overruled, except to the limited extent that reclamation expenses might be accrued under the exception to the economic performance rules for certain recurring items provided by I.R.C. § 461(h)(3).

(f) Effective Date

Section 91(g) of the Tax Reform Act of 1984 provides that I.R.C. § 468 is generally effective for expenses incurred after the date of enactment (i.e., July 18, 1984). However, section 91(h)(2) of the Tax Reform Act provides that I.R.C. § 468 and I.R.C. § 461(h) do not apply to fixed price mineral supply contracts entered into prior to March 1, 1984. Taxpayers selling minerals under such contracts may continue an existing practice of accruing estimated expenses on current dollar basis, if the supply contract does not permit a price adjustment to reflect changes in tax liability. *See* House Report 98-861, 98th Cong. 2d Sess. 880, 882-83 (1984) for a discussion of the treatment of a property where a portion of the production is sold under a fixed price contract and a portion is not.

C. Well Plugging

Closing costs for an oil or gas well will be deductible in the year incurred under the taxpayer's method of accounting. The "economic performance" limitation on accruals will apply to defer the deduction until the year the taxpayer or a third party performs the services. *See* Rev. Rul. 80-182, 1980-1 C.B. 167.

IX. DISPOSITION OF MINERAL PROPERTIES

A. *Sales*

1. Recognition of Gain

The sale of the fee or the entire leasehold interest in a solid mineral, oil or gas deposit in the ground will be taxed under I.R.C. § 1001. Gain will be recognized to the extent the amount realized exceeds the adjusted basis of the property. Computation of adjusted basis requires that the unadjusted basis be reduced (but not below zero) for any prior depletion claimed by the seller. I.R.C. § 1016(a)(2); Treas. Reg. § 1.1016-3(b). Loss will be recognized if the basis exceeds the amount realized.

Section 453 installment sale treatment will be available if the purchase price is to be paid in installments. *See* Rev. Rul. 68-266, 1968-1 C.B. 362. If the price and installments are contingent upon production, however, the disposition will be treated as a lease rather than an installment sale. *See* Part IX.A.3. *infra*. Because mineral properties are real property, *see* Rev. Rul. 68-331, 1968 - 1 CB 352; *Commissioner v. Critchton*, 122 F.2d 181 (5th Cir. 1941), an installment sale of a mineral property used in the taxpayer's trade or business — essentially any working interest held by an operator — may be subject to I.R.C. § 453A. This provision applies to installment sales made after 1987 if the sales price exceeds $150,000, but only if the face amount of all obligations from and installment sales of real estate (for a price of more than $150,000) arising during the year and outstanding at the end of the year exceeds $5,000,000. When it applies, I.R.C. § 453A imposes an interest charge on the deprived tax liability. In addition, I.R.C. § 453(A)(d) treats loan proceeds from any loan secured by the pledge of an obligation subject to I.R.C. § 453A as a payment received on the obligaton, thereby triggering recognition of gain. Section 453(A) does not apply to property held for investment.

2. Character of Gain or Loss

Gain or loss recognized upon the sale of a mineral property may be ordinary, capital, or I.R.C. § 1231 gain or loss, depending upon the purpose for which the taxpayer held the property. For properties first placed in service after December 31, 1986, even if the mineral property is an I.R.C. § 1231 asset, gain will be recaptured as ordinary income under I.R.C. § 1254 to the extent of (1) solid mineral exploration expenditures previously deducted and unrecaptured under I.R.C. § 617, (2) solid mineral development expenditures previously deducted under I.R.C. § 616 or oil and gas IDC previously deducted under I.R.C. § 263(c) that otherwise would have been included in the basis of the property, and (3) depletion deductions, without regard to whether the taxpayer claims cost or percentage depletion (but not in excess of basis) previously claimed with respect to the property. For oil and gas properties placed in service prior to 1987, I.R.C. § 1254 (as in effect prior to the Tax Reform Act of 1986) provides for a more limited form of recapture of IDC.

Although a broad recapture rule was introduced in 1986, its significance was simultaneously greatly diminished. For taxable years after 1986, the capital gains preference provided by I.R.C. §§ 1201 and 1202, (as in effect prior to the Tax Reform Act of 1986) has been repealed. Capital gains are now taxed at the same rate as ordinary income. (For 1987, when the maximum rate of tax for individuals exceeded 28%, a transition rule limited the maximum rate of tax on capital gains to 28% for individuals.) Despite the repeal of the capital gains preference, the restrictions on the deduction of capital losses have been retained. *See* I.R.C. §§ 1211, 1212. Thus, the distinction between ordinary and capital gains and losses can be very important when the interaction with other items on the taxpayer's return is considered.

A dealer in mineral properties recognizes ordinary gain or loss. *Greene v. Commissioner*, 141 F.2d 645 (5th Cir. 1944), *cert. denied*, 323 U.S. 717 (1944); Rev. Rul. 73-428, 1973-2 C.B. 303 (sale of royalty interest).

If the property is held for use in the seller's trade or business (that is, the seller is in the business of extracting minerals from leased or owned property), the gain or loss may be I.R.C. § 1231 gain or loss (which may result in ordinary losses and capital gains). *See Bailey v. Commissioner*, 21 T.C. 678 (1954); Rev. Rul. 68-226, 1968-1 C.B. 362; *Butler Consolidated Coal Co. v. Commissioner*, 6 T.C. 183 (1946), (*acq.*) (treating loss on sale as capital loss for year prior to enactment of I.R.C. § 1231).

If the property is held as an investment, the gain or loss is a capital gain or loss as defined in I.R.C. § 1221. *See* Rev. Rul. 73-428, 1973-2 C.B. 303 (sale of royalty interest).

3. Distinguishing Sales From Leases

The hallmark for distinguishing a sale from a lease is whether the transferor has retained an economic interest in the mineral deposit. If the transferor has *not* retained an economic interest the transaction is a sale. *Burnet v. Harmel*, 287 U.S. 103 (1932); Rev. Rul. 69-352, 1969-1 C.B. 34. For an exposition by the Tax Court of the test for distinguishing sales from leases based upon a "risk analysis", *see O'Connor v. Commissioner*, 78 T.C. 1 (1982).

If the transferor retains an economic interest in the deposit, the transaction is a lease and the transferor will realize ordinary income subject to depletion in the case of oil and gas and solid minerals, including coal and iron ore not meeting the holding period requirement of I.R.C. § 631(c). *See Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946); *Herring v. Commissioner*, 293 U.S. 322 (1934); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1932); *Burnet v. Harmel*, 287 U.S. 103 (1932); Rev. Rul. 69-352, 1969-1 C.B. 34. In the case of a disposition of coal or domestic iron ore in which the transferor retains an economic interest — a lease — meeting the one year holding period and other requirements of I.R.C. § 631(c), the lessor receives I.R.C. § 1231 treatment, but in years in which capital gains are taxed at the same rate as ordinary income, as is presently the case, a coal or domestic iron ore lessor may instead claim percentage depletion. *See* Part IX.C., *infra*.

However, if the *only* retained economic interest is a production payment (*see Thomas v. Perkins*, 301 U.S. 655 (1927)), under I.R.C. § 636(b), the transaction will be treated as a sale with a purchase money mortgage loan, and the transferor will not be treated as having an economic interest. *See* Treas. Reg. § 636-1(a)(1), (c) (Example 3).

A mineral property may be sold in an installment sale under I.R.C. § 453, but if the deferred payments are neither subject to a fixed ceiling nor payable over a limited time, the transaction may be recharacterized as a lease and the payments treated as royalties. See Treas. Reg. § 15A.453-1(c).

In *Deskins v. Commissioner*, 87 T.C. 305 (1986), the taxpayer disposed of coal pursuant to a document entitled "Coal Lease." Under the "lease," the taxpayer was to receive an annual minimum royalty of $430,000 for 10 years. The royalty was recoupable and total royalties were limited to $4,300,000 over the life of the lease. The taxpayer retained no reversionary interest in any of the minerals, even if minerals remained unmined at the end of ten years. Because the transferor was entitled to receive exactly $4.3 million, no more and no less, regardless of the amount of coal mined by the transferee, the Tax Court held that the transaction was a sale, not a lease. Thus, interest was to be imputed on the deferred payments. If the transaction had been a lease, all payments would have been treated as amounts realized on I.R.C. § 1231 property.

B. Leases of Minerals Other Than Coal and Iron Ore Eligible For I.R.C. Section 631(c) Treatment, Including Oil and Gas

1. Generally

All payments received by a lessor under the lease are ordinary income and, except for delay rentals (*see* Treas. Reg. § 1.612-3(c)), are generally subject to the depletion allowance. The lessor's depletable income corresponds to the "rents and royalties" that must be excluded by a lessee in computing percentage depletion under I.R.C. § 613 and § 613A. Some early cases indicate that when a royalty is paid in kind or, in the case of oil and gas, when the royalty is paid directly to the lessor by the purchaser pursuant to a division order, the lessee excludes the amount of the royalty from gross income for purposes of I.R.C. § 61. *See, e.g., Thomas v. Perkins*, 301 U.S. 655 (1937). When the lessee receives payment of the full purchase price and remits the royalty in cash, however, the lessee should include the full sales price, less cost of goods sold, in income and deduct the royalty as an ordinary and necessary business expense under I.R.C. § 162. *Commissioner v. Jamison Coal & Coke Co.*, 67 F.2d 342 (3d Cir. 1933) (advance minimum royalties); *Ramsey v. Commissioner*, 83 T.C. 793, 810 (1984) (purported advance minimum royalties; deduction denied); *Buffalo Eagle Mines, Inc. v. Commissioner*, 37 B.T.A. 843, 850 (1938) (royalties). In determining the lessee's "gross income from the property" for purposes of depletion, however, royalties are excluded whether paid in cash, in kind, or pursuant to a division order. *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934).

2. Depletable Income

Depletable income includes:

(1) Royalties, *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312 (1934), including minimum royalties, *McLean v. Commissioner*, 54 T.C. 569 (1969); Rev. Rul. 72-165, 1972-1 C.B. 177; *Handleman v. United States*, 357 F.2d 694 (Ct. Cl. 1966).

(2) Overriding Royalties retained by a sublessor, *Palmer v. Bender*, 287 U.S. 551 (1933).

(3) Net profits payments, *Kirby Petroleum Co. v. Commissioner*, 328 U.S. 25 (1946).

(4) Bonus Payments, *Burnet v. Harmel*, 287 U.S. 103 (1932); *Murphy Oil Co. v. Burnet*, 287 U.S. 299 (1933); *Commissioner v. Engle*, 464 U.S. 206 (1984); Treas. Reg. § 1.612-3(a)(1),(d). Any bonus, advance royalty, or any other amount payable without respect to production received with respect to an oil or gas property after August 16, 1986 in a taxable year ending after that date will not be eligible for percentage depletion pursuant to I.R.C. § 613A(d)(5). This provision, which was added by the Tax Reform Act of 1986, legislatively overrules *Engle*, which allowed percentage depletion on bonuses and advance royalties received by independent royalty owners to whom percentage depletion is generally available notwithstanding the general disallowance of percentage depletion for oil and gas by I.R.C. § 613A.

If a production payment is retained together with royalties or a net profits interest, then the production payment will be treated as a lease bonus payable in installments, I.R.C. § 636(c), and unless I.R.C. § 613A(d)(5) applies (oil and gas) the receipts will be subject to depletion. Treas. Reg. § 1.636-2(b).

If a bonus is received in connection with the transfer of a working property, including depreciable equipment and structures, a portion of the bonus will be treated as an amount realized upon the sale of the depreciable property. *Choate v. Commissioner*, 324 U.S. 1 (1945); *see, e.g., Kline v. Commissioner*, 268 F.2d 854 (9th Cir. 1959); *Louisiana Land & Exploration Co. v. Commissioner*, 6 T.C. 172 (1946) (*acq.*).

(5) Advance royalties, *Herring v. Commissioner*, 293 U.S. 322 (1934); *Commissioner v. Engle*, 464 U.S. 206, (1984); Treas. Reg. § 1.612-3(b)(1),(2),(4) and (d). Section 613A(d)(5) disallows percentage depletion for advance royalties received with respect to oil and gas properties received after August 16, 1986 in taxable years ending after that date.

No depletion is allowed with respect to:

(1) Option payments received. *Commissioner v. Pickard*, 401 F.2d 615 (10th Cir. 1968).

(2) Delay rentals, Treas. Reg. § 1.612-3(c)(2). A delay rental is defined as "an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, . . . by commencement of development operations, or by obtaining production. Treas. Reg. § 1.612-3(c)(1). *See White Castle Lumber and Shingle Co. v. United States*, 481 F.2d 1274 (5th Cir. 1973) (treating acreage selection bonuses as delay rental).

(3) Carved out production payments, consideration for which was not pledged to development are not depletable. I.R.C. § 636(a); Treas. Reg. § 1.636-1(a)(3) (Ex. 1).

3. Bonuses and Advance Royalties: Year of Lessor's Inclusion

The lessor includes in income and claims depletion on bonuses, advance royalties and minimum royalties in the year of receipt or accrual. Treas. Reg. § 1.612-3(a)(1), (b)(1). *See* Announcement 84-59, Rev. Rul., 1984-1 C.B. 5 (regarding the limitation of the depletion deduction for bonuses and advance royalties received by a lessor of oil and gas properties eligible to claim percentage depletion under I.R.C. § 613A prior to the addition of I.R.C. § 613A(d)(5) by the Tax Reform Act of 1986 disallowing percentage depletion on bonuses and advance royalties, by attributing a number of barrels of oil to the payment).

4. Recapture of Depletion on Bonuses and Advance Royalties

(a) Bonuses

All of the depletion (either cost or percentage) claimed with respect to a bonus must be recaptured in income if the lease is surrendered prior to any production. *Douglas v. Commissioner*, 322 U.S. 275 (1944); Treas. Reg. § 1.612-3(a)(2). Any production, however, even if slight, will defeat recapture. *Crabb v. Commissioner*, 41 B.T.A. 686 (1940). *But see Campbell v. Commissioner*, 41 T.C. 91 (1963) (questioning *Crabb*). But if the lessor disposes of his entire leasehold interest prior to abandonment, recapture can be avoided. Rev. Rul. 60-336, 1960-2 C.B. 195. *Compare Waggoner v. Commissioner*, 47 B.T.A. 699 (1942) (*acq.*) (requiring full recapture where taxpayer disposed of only undivided one half interest prior to abandonment of lease).

(b) Advance Royalties

Depletion (either cost or percentage) claimed with respect to advance royalties will be recaptured in income if the lease is abandoned prior to extraction of all of the minerals (oil and gas) to which the advance royalty relates. Treas. Reg. § 1.612-3(b)(2). Recapture is limited to the depletion on advance royalties relating to the unextracted units and the taxpayer increases his depletable basis in the amount of the recaptured depletion.

5. Lessee's Treatment of Advance Royalties and Bonus Payments

Advance royalties paid with respect to a mineral property are excluded from gross property income in computing depletion and deducted from gross income in computing taxable income in the year of sale of the mineral to which the royalties relate, not in the year of payment or accrual. Treas. Reg. §§ 1.613-2(c)(5)(iii), -3(b)(3) (1977). Advance royalties paid under a minimum royalty provision are treated in the same manner as other advance royalties in computing the depletion allowance. According to Treas. Reg. § 1.613-2(c)(5)(iii), if the taxpayer validly elects to deduct advance minimum royalties as provided in Treas. Reg. § 1.612-3(b)(3), in computing taxable income for purposes of I.R.C. § 63 in the year of payment or accrual, the royalties will be excluded from gross income from the property in the year paid, rather than in the year of sale of the mineral to which they relate. The regulations allow such an election only for a minimum royalty in a substantially uniform amount extending for the lessor for at least twenty years of the lease term, including renewal or extension terms. Treas. Reg. § 1.612-3(b)(3). Notwithstanding the clear directive of the regulations, the I.R.S. has ruled that advance minimum royalties deducted when paid for purposes of computing taxable income under I.R.C. § 63 are deducted in computing gross income from the property under the same rule governing advance royalties generally. Rev. Rul. 79-386, 1979-2 C.B. 246. This position finds no support in the regulations.

Numerous cases decided over the last few years have disallowed deductions for advance minimum royalties paid by tax shelter partnerships. In most, if not all cases, the royalties were "paid" by the delivery to the lessor of nonrecourse promissory notes payable only out of future production or the partnership was otherwise protected through interrelated contracts from any economic loss from payments in the absence of production. *See, e.g.*, *Brown v. Commissioner*, 799 F.2d 27 (2d Cir. 1986); *Maddrix v. Commissioner*, 83 T.C. 613 (1984), *aff'd* 780 F.2d 946 (11th Cir. 1986); *Wing v. Commissioner*, 81 T.C. 17 (1983). Most of these cases turn on the insufficient possibility of payments actually being made or the absence of forfeiture of the lessee's rights for an extended period of time following nonpayment. Thus, the payments are not "required," which is a prerequisite for advance minimum royalties to be deductible.

Lease bonus payments are accorded treatment similar to advance royalties in computing the depletion allowance. The amount excluded during each year is that portion of the bonus allocable to the mineral sold during that year. Treas. Reg. § 1.613-2(c)(5)(ii) (1977); Rev. Rul. 79-73, 1979-1 C.B. 218. The allocation, based on spreading the lease bonus over the estimated reserves and excluding from gross income from the property each year the amount allocated to the number of tons sold during the year, is substantilly similar to the cost depletion formula. See Treas. Reg. § 1.613-2(c)(5)(ii) (1977) (Example 1).

Although a lease payment bonus is excluded from gross income from the property under I.R.C. § 613(a) for purposes of computing the lessee's depletion allowance, for purposes of computing the lessee's taxable income, the bonus allocable to the year of production is neither excluded from gross income under I.R.C. § 61 nor deductible under any section in determining taxable income. *Id.*; *Sunray Oil Co. v. Commissioner*, 147 F.2d 962 (10th Cir. 1945), *cert. denied*, 325 U.S. 861 (1945); *Shamrock Oil &*

Gas Corp. v. Commissioner, 346 F.2d 377 (5th Cir. 1965); Rev. Rul. 79-73, 1979-1 C.B. 218. There is no deduction because the payment of the bonus is a capital expenditure to be recovered through depletion. Treas. Reg. § 1.612-3(a)(3) (1977); *see Murphy Corp. v. United States*, 337 F.2d 677 (8th Cir. 1964). Nevertheless, the bonus payment must be excluded from the lessee's gross income from the property because it is depletable to the lessor. Treas. Reg. § 1.612-3(a) (1977). Thus, oil and gas lessees must exclude bonuses and advance royalties on which the lessor may not claim percentage depletion because the lessor may claim cost depletion. The effect of these provisions is to deny a lessee effective tax recovery of the expenditure of a lease bonus when percentage depletion under either I.R.C. § 613 or I.R.C. § 613A is claimed.

C. Leases of Coal and Domestic Iron Ore Deposits

1. Generally

For years prior to 1987, the lessor of a coal or domestic iron ore deposit generally does not realize ordinary income subject to depletion, but instead, under I.R.C. § 631(c) is entitled to treat the excess of royalties received over the basis allocable to the royalties received as I.R.C. § 1231 gains. This results in effectively claiming cost depletion and treating the gains as capital gains. Losses are treated as ordinary losses. *See* Treas. Reg. § 1.631-3(a). Section 631(c) applies to any "disposal" of coal or iron ore "under any form of contract by virtue of which . . . [the] owner retains an economic interest in such coal or iron ore. . . ." Thus, for example, a transfer of all interest in a coal deposit in exchange for an interest in the net profits realized by the transferee from extraction and sale would qualify. Section 631(c) is not elective; for years prior to 1987, a lessor could not claim percentage depletion if to do so would have been more advantageous. *See* Treas. Reg. § 1.631-3(b)(1).

For taxable years beginning after December 31, 1986, the capital gains preference has been repealed. Nevertheless, I.R.C. § 631(c) continues to treat coal and iron ore royalties that meet the requirements of that section as an amount realized on the disposition of I.R.C. § 1231 property. However, I.R.C. § 311(b)(3) of the Tax Reform Act of 1986 amended I.R.C. § 631(c) to provide that a coal lessor would be denied a depletion allowance only in years in which the maximum rate of tax on capital gains is less than the maximum rate of tax on ordinary income for the owner (i.e., lessor) of the coal. Thus, after 1986 (subject to the transition year rules in 1987 in which the maximum rate of tax for individuals was less than the maximum rate of tax on ordinary income), if the statute is read literally, coal and iron ore lessors realize I.R.C. § 1231 gain or loss equal to the difference between the royalty and the allocable basis of the deposit *and* may claim the depletion allowance.

There is no *logical* way both to allow percentage depletion as an alternate to cost depletion *and* to treat the difference between the royalty and allocable basis of the coal as I.R.C. § 1231 gain. The legislative history indicates that Congress intended that coal and iron ore royalties simply would be treated as ordinary income subject to either cost or percentage depletion, as the case may be. *See* H.R. Rep. No. 99-841, 99th Cong., 2d Sess., Pt. II, at 127 (1986). Thus coal and iron ore lessors would be treated in the same manner as lessors of any other solid mineral. A technical correction may be necessary, however, to eliminate the I.R.C. § 1231 treatment that is mandated by I.R.C. § 1231(b)(2), which was not repealed by the Tax Reform Act of 1986, unless the intent of Congress was that gains and losses when cost depletion is claimed will be I.R.C. § 1231 gain or loss, but when percentage depletion is claimed, the income and deduction items will be ordinary. This would be nonsensical, and it is unlikely that such a result was intended.

2. Section 1231 Treatment

For taxable years prior to 1987, and for any taxable years after 1986 in which the maximum rate of tax on the lessor's capital gains is greater than the maximum rate of tax on its ordinary income, including 1987 under the transition rates, the rules of I.R.C. § 631(c) governing coal royalties are as follows.

(a) Basic Qualifications

There are a number of conditions that must be met to qualify for I.R.C. § 631(c) treatment.

(1) Holding Period

The lessor must have held the coal or iron ore disposed of for more than one year (six months if the deposit or iron ore property was acquired after June 22, 1984 and before January 1, 1988). In determining the holding period, however, the date of "disposition" for purposes of I.R.C. § 631(c) is the date that the coal or iron ore is mined, not the date of the lease. Treas. Reg. § 1.631-3(b)(1). Thus, if a coal property were acquired on July 1, 1988, and on the same day leased to another party, royalties received with respect to coal mined between July 1, 1988 and July 1, 1989, inclusive, would not be eligible for I.R.C. § 631(c) treatment but would be ordinary income subject to depletion. All royalties received with respect to coal mined after January 1, 1985, would receive I.R.C. § 631(c) treatment.

(2) Ownership

Although I.R.C. § 631(c) initially purports to apply only to the "disposal" by an "owner," the section also provides that "the word 'owner' means any person who owns an economic interest in coal or iron ore in place, including a sublessor." *See* Treas. Reg. § 1.631-3(b)(3)(ii)(a). Successors in interest to an owner who have disposed of coal or iron ore under a contract pursuant to which royalties are eligible for I.R.C. § 631(c) treatment are also eligible for the preference. Treas. Reg. § 1.631-3(b)(4)(i). Rev. Rul. 59-416, 1959-2 C.B. 159 illustrates the meaning of the term "successor in interest." Included are (1) devisees and legatees; (2) purchasers or assignees (but not sublessees) of the entire or an undivided interest of the original owner; (3) donees; and (4) former shareholders of a corporation who acquire their interest in liquidation of the corporation. However, with the exception of donees who succeed to the donor's basis for both gain and loss under I.R.C. § 1015 and shareholders who acquire the interest in a liquidation subject to now repealed I.R.C. § 333, the successor in interest must establish a new holding period.

(3) Disposition

Section 631(c) applies only to a "disposal" of coal or iron ore with a "retained" economic interest. It does *not apply* to royalties received with respect to an economic interest held by a person who has not "disposed" of coal or iron ore. Treas. Reg. § 1.631-3(b)(4)(i).

The holder of a royalty granted to the owner of surface rights in consideration of granting the owner of the mineral deposit (including a lessee) access to the deposit is not entitled to I.R.C. § 631(c) treatment. The royalty is, however, an economic interest and the royalties are depletable. *See Omer v. United States*, 329 F.2d 393 (6th Cir. 1964); *Newton v. United States*, 584 F. Supp. 116 (N.D. Ala. 1984); Rev. Rul. 79-144, 1979-1 C.B. 219. This rule has been applied where the lessor owned the entire interest in the surface but only an undivided interest in the underlying coal. *Martin v. United States*, 409 F.2d 13 (6th Cir. 1969). However, the lessor of both the surface and mineral rights for a unitary royalty is entitled to I.R.C. § 631(c) treatment on the entire royalty. Priv. Ltr. Rul. 7905006.

A royalty granted as a finder's fee or for negotiating a mineral lease is not subject to I.R.C. § 631(c). The royalty is an economic interest and royalties attributable to the mineral property are depletable. *See Cline v. Commissioner*, 67 T.C. 889 (1977), *aff'd*, 617 F.2d 192 (6th Cir. 1980); Rev. Rul. 77-84, 1977-1 C.B. 173; *see also* Rev. Rul. 83-46, 1983-1 C.B. 16 (ruling that receipt of royalty interest is taxable under I.R.C. § 83(a) at the time royalty interest is created). Rev. Rul. 73-80, 1973-1 C.B. 308, held that the grantor of an option to purchase a mineral property who received a royalty interest to be paid upon commencement of operations could deplete the royalty received for the option.

The purchaser of an overriding royalty interest may not claim I.R.C. § 631(c) treatment. Treas. Reg. § 1.631-3(b)(4)(ii) (Ex. 2).

(b) Basis

Section 631(c) accords I.R.C. § 1231 treatment to royalties received in excess of the owner's "adjusted depletion basis." This is the basis for cost depletion as provided in I.R.C. § 612. Treas. Reg. § 1.631-3(b)(2). The depletion unit for the royalties attributable to the coal or iron ore disposed of is determined under Treas. Reg. § 1.611-2(a)(1). *See* Part I.B.2. (for the applicable rules). The regulations specifically provide that development expenditures capitalized under I.R.C. § 616(b) will be added to basis rather than separately amortized. Treas. Reg. § 1.631-3(b)(2). This is in contrast to the normal rules governing amortization of capitalized development expenses under I.R.C. § 616(c). *See* Part VI.B.2., *supra*.

The regulations provide that a lessee who is also a sublessor must increase his depletion basis for the year by royalties paid rather than exclude them from gross income. Treas. Reg. § 1.631-3(b)(3)(ii)(a).

(c) Treatment of Expenses

Section 272 disallows any deduction for expenditures attributable to making or administering a contract for the disposal of coal or domestic iron ore subject to I.R.C. § 631(c) or preserving the taxpayer's economic interest in the property, except to the extent such expenditures exceed the royalties attributable to any particular year. Expenditures subject to I.R.C. § 272 are added to the basis of the property allocable to the year in which paid or accrued for the purposes of computing gain subject to I.R.C. § 1231 through I.R.C. § 631(c). Treas. Reg. § 1.272-1(a), (b)(1). If the expenditures plus the depletion unit exceed the royalties received, the excess is an I.R.C. § 1231 loss. If the losses are not fully absorbed by I.R.C. § 1231 gains, the excess is deductible as a loss under I.R.C. § 165(a). Treas. Reg. § 1.272-1(c).

Expenditures subject to I.R.C. § 272 include, but are not limited to, state *ad valorem* taxes, interest on loans, legal expenses, expenses of measuring and checking quantities of coal or iron ore disposed of under the contract, and bookkeeping expenses. Treas. Reg. § 1.272-1(d)(1). Expenditures attributable to more than one property must be apportioned among the properties. In *Higgins Co. v. United States*, 39 A.F.T.R. 2d (P-H) 702 (D. Minn.), *aff'd*, 566 F.2d 595 (8th Cir. 1977), involving a corporation whose only income was from iron ore royalties subject to I.R.C. § 631(c), the court held that state income taxes were not payments attributable to the making or administering of the contract or for the preservation of the economic interest, and were therefore not an addition to basis under I.R.C. § 272. Nevertheless, the court denied a current deduction. This is difficult to understand because the language describing the expenses for which a deduction is disallowed is the same as the language describing the expenses that must be added to basis.

With the repeal of the capital gains preference and the extension of percentage depletion to coal and iron ore royalties, it would appear that I.R.C. § 272 should not apply in any year that the taxpayer claims percentage depletion. If it does apply, the lessee is effectively denied a deduction for these expenses since the deduction would be subsumed in the percentage depletion allowance. To do this would be to treat coal and iron ore lessors more harshly than lessors of any other mineral subject to percentage depletion. Section 272 does not apply to any other minerals, and those lessors may deduct the expenses described in I.R.C. § 272 in addition to claiming percentage depletion. The result of the 1986 legislation should be to accord the same treatment to coal and iron ore lessors as is accorded to all other mineral lessors. To achieve this, I.R.C. § 272 must be treated as inapplicable in any year in which percentage depletion is allowed for coal and iron ore royalties. Unfortunately, however, due to the ambiguities in amended I.R.C. § 631(c), discussed *supra*, coal and iron ore lessors may be subjected to this harsh result under I.R.C. § 272 if the language of the two provisions is read literally.

(d) Advance Royalties and Bonuses

(1) Lessor's Treatment

(i) Generally

Both bonuses and advance royalties received with respect to a disposal of coal and iron ore qualifying for I.R.C. § 631(c) treatment may receive favorable tax treatment together with royalties, to the extent that the payments are attributable to coal and iron ore mined at a future time that meets the holding period requirement of I.R.C. § 631(c). *See* Treas. Reg. § 1.631-3(c)(3). If the owner has held the property for more than one year, this presents no problem. But if the owner has not held the mineral property for more than one year (for example, a lessee who promptly subleases), then the advance royalties and bonus must be allocated between the coal and iron ore that qualifies for I.R.C. § 631(c) treatment and that which does not. While this allocation may be readily apparent for advance royalties, the computation for bonuses is more complex. The principles of

Treas. Reg. § 1.631-2(d), dealing with timber, govern under a cross reference from Treas. Reg. § 1.631-3(c)(3).

Rev. Rul. 69-166, 1969-1 C.B. 37 treated the portion of a lease option payment credited against the bonus paid to the lessor in a disposal of coal qualifying for I.R.C. § 631(c) treatment as a payment subject to I.R.C. § 631(c) in the hands of the lessor.

(ii) Recapture

If the lessee abandons the lease or the lease otherwise terminates before the lessee mines the coal to which advance payments are attributable, the owner must amend his *original* return if the statute of limitations is still open, to account for the payments as ordinary income if they were originally reported as I.R.C. § 1231 gains. Treas. Reg. § 1.631-3(c)(2). Only those advance royalties attributable to unmined coal or iron ore are recomputed as ordinary income. Rev. Proc. 77-11, 1977-1 C.B. 568. To accord coal and iron ore the same treatment as other minerals, no depletion should be allowed. *See* Treas. Reg. § 1.612-3(a)(2), 3(b)(2); *see also* Part IX.B.4, *supra* . The entire bonus is recomputed as ordinary income if the lease terminates before any coal has been mined. *Id.* Apparently, no recomputation of the bonus is necessary if *some* coal or iron ore has been mined. For years after 1986, advance coal and iron ore royalties and bonuses should be subject to the same recapture rules as other minerals.

(2) Sublessor's Treatment

Section 1.631-3(b)(3)(ii)(a) of the Treasury Regulations requires that a lessee who is also a sublessor must increase the adjusted depletion basis for the coal or iron ore by the amount of advance minimum royalties. This overrides Treas. Reg. § 1.612-3(b)(3), which otherwise allows a lessee to deduct advance minimum royalties from gross income and gross income from the property in the year of production of the mineral to which the royalties relate. It also overrides the rule of Treas. Reg. § 1.612-3(b)(3) permitting deduction of substantially uniform advance minimum royalties from gross income in the year paid. *Davis v. Commissioner*, 746 F.2d 357 (6th Cir. 1984), *aff'g* 74 T.C. 881 (1980), upheld Treas. Reg. § 1.631-3(b)(3)(ii)(a) and applied it to advance minimum royalties paid *before* the lessee subleased the coal deposit because the lessee-sublessor never intended to mine the coal, but at all times intended to sublease the deposit. *See also Maddrix v. Commissioner*, 83 T.C. 613 (1984), *aff'd*, 780 F.2d 946 (11th Cir. 1986), (taxpayer was denied a deduction for advance minimum royalties "paid" by delivery of a nonrecourse promissory note, payable only out of the proceeds of production; arrangement was not a minimum royalty payment).

As long as coal and iron ore royalties were accorded preferential capital gains treatment this rule was logical to prevent the conversion of ordinary income into more lightly taxed capital gains. With the elimination of the capital gains preference and the extension of percentage depletion to coal royalties, however, this rule loses its logical coherence, at least insofar as the treatment of coal and iron ore is compared with other minerals. All other mineral lessee-sublessors may exclude (or deduct) royalties paid to their lessor in addition to claiming percentage depletion. To deny this privilege to coal and iron ore lessors will deny an effective exclusion of royalties paid when percentage depletion is claimed because the royalty exclusion will be subsumed into the larger cost depletion allowance. No other mineral lessee-sublessor suffers this fate.

(e) Unavailability for Operators and Lessors to Related Parties

(1) Generally

Section 631(c) specially provides that its benefits do not extend to "income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal. . . ." This proscription of beneficial treatment is intended to apply when the "owner of the coal [or iron ore] was personally obligated to share in the cost of the mining operations." *See* S. Rep. No. 781, 82nd Cong., 1st Sess., 43 (1951). Thus, an owner who hires a contract miner, whether or not the contract miner has an economic interest under *Parsons v. Smith*, 359 U.S. 215 (1959), may not avail himself of I.R.C. § 631(c) to treat his profits from the sale of extracted coal as capital gain. *Cf. Ruston v. Commissioner*, 19 T.C. 284 (1954), (discussed in Part II.B.3.b., *supra*).

(2) Related Party Leasing

(i) Before Tax Reform Act of 1984

Prior to the Tax Reform Act of 1984, I.R.C. § 631(c) did not expressly prohibit a lessor who was related to the lessee from availing itself of favorable capital gains treatment for coal royalties under I.R.C. § 631(c), although it did expressly proscribe such treatment for leases of iron ore between related parties. Thus, by subleasing the coal deposit to a wholly-owned corporation or a partnership of which the lessor(s) was a partner, the lessor could convert a portion of his income to capital gains, and in addition, effectively claim both cost depletion and percentage depletion on the extracted coal. The small reduction in percentage depletion (ten percent of the royalties) was more than offset by the cost depletion and conversion of a portion of the income to capital gains. In *Keller Mines Inc. v. Commissioner*, 31 T.C.M. (P-H) ¶ 62,031 (1962), the Tax Court allowed I.R.C. § 631(c) treatment to a partnership that leased a coal deposit to a corporation that was owned by the partners. *See also Merritt v. Commissioner*, 39 T.C. 257 (1962).

Rev. Rul. 73-33, 1973-1 C.B. 307 allowed I.R.C. § 631(c) treatment to a power company that for a fair and reasonable royalty leased a coal deposit to a joint venture that was equally owned by a wholly-owned subsidiary of the power company and an unrelated mining company. The joint venture and the power company then entered into a coal supply agreement obligating the power company to purchase all of the requirements for one of its plants from the joint venture. Despite the relationship between the lessor and lessee and the simultaneous execution of the lease and supply contract, the I.R.S. ruled that I.R.C. § 631(c) was applicable. *See also* Rev. Rul. 74-10, 1974-1 C.B. 251 (lease from one subsidiary of common parent to another subsidiary).

But in Rev. Rul. 68-430, 1968-2 C.B. 44, the I.R.S. held that a sale and leaseback of a coal deposit between a parent corporation and subsidiary that was entered into for the purpose of obtaining both cost and percentage depletion was to be disregarded for tax purposes. A similar result was reached in *Valley Camp Coal Co. v. Commissioner*, 36 T.C.M. (P-H) ¶ 67, 225 (1967), *aff'd*, 405 F.2d 1208 (6th Cir. 1969). After negotiations with a seller were well advanced, an active mining corporation arranged for an inactive subsidiary to purchase the coal deposits with funds produced by the parent, and the parent then leased the coal from the subsidiary. The Tax Court found the form of the transactions to be artificial; the parent was the true owner.

(ii) After the Tax Reform Act of 1984

The Tax Reform Act of 1984 amended I.R.C. § 631(c) to subject coal leases to the same restrictions on the availability of I.R.C. § 631(c) for royalties received by a lessor under a lease to a related party as had previously applied only to iron ore leases. Section 1231 treatment under I.R.C. § 631(c) now will be unavailable for royalties received under a coal lease to a person (which as defined in I.R.C. § 7701(a)(1) includes individuals, trusts, estates, partnerships, corporations and associations) whose relationship to the person disposing of such iron ore or coal would result in the disallowance of losses under I.R.C. § 267 or I.R.C. § 707(b), or "to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such . . . coal."

The relationships in I.R.C. § 267 and I.R.C. § 707(b) to which reference is made include, but are not limited to:

(1) Members of a family (defined as brothers and sisters, spouse, ancestors, and lineal descendents). I.R.C. § 267(b)(1), (c)(3).

(2) An individual and corporation more than fifty percent of the value of the outstanding stock of which is owned, directly *or indirectly*, by or for such individual. I.R.C. § 267(b)(2).

(3) Two corporations that are members of a controlled group, using the definition in I.R.C. § 1563(a) but using a "more than 50 percent" test rather than "at least fifty percent." I.R.C. §§ 267(b)(3), (f)(1). Thus, if A Corp. owns fifty-one percent of the stock of B Corp. and A Corp. leases coal to B Corp., I.R.C. § 631(c) does not apply. Nor would I.R.C. § 631(c) treatment be available if C Corp. leased coal to D Corp., and E Corp. owned fifty-one percent of both C Corp. and D Corp.

(4) A trust and:

(a) a grantor, I.R.C. § 267(b)(4)

(b) a beneficiary, I.R.C. § 267(b)(6)

(c) another trust with a common grantor, I.R.C. § 267(b)(5).

(5) A corporation and a partnership if the same persons own more than fifty percent of the value of stock of the corporation and more than fifty percent of either the capital or profits interest in the partnership. I.R.C. § 267(b)(10). This rule reverses the result in *Keller Mines Inc.*, but probably does not affect Rev. Rul. 73-33, *supra*, where the power company lessor appeared to be exactly a fifty percent partner in the lessee joint venture.

(6) An S Corporation and another S Corporation or a C Corporation, if the same persons own more than fifty percent of the value of the outstanding stock of each corporation. I.R.C. §§ 267(b)(11), (b)(12). In determining stock ownership the constructive ownership rules of I.R.C. § 267(c) apply.

(7) A partnership and a partner who directly or indirectly owns more than fifty percent of the profits or capital interest of the partnership. I.R.C. § 707(b)(1)(A). The constructive ownership rules of I.R.C. § 267(c) are applied to determine ownership. I.R.C. § 707(b)(3).

(8) Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interests. I.R.C. § 707(b)(1)(B). I.R.C. § 267(c)(3) (constructive ownership rules apply).

Even if the lessor and lessee are not within one of the relationships listed in I.R.C. § 267(b) or I.R.C. § 707(b), the catchall "common control" relationship may preclude I.R.C. § 631(c) treatment of royalties. For this purpose, the presence or absence of control is determined using the same standards as are applied under I.R.C. § 482. See Treas. Reg. § 1.631-3(e)(5) (iron ore related party lease rules). Under I.R.C. § 482 control "includes any kind of control, direct or indirect, whether legally enforceable, and however . . . exercised." Treas. Reg. § 1.482-1(a)(3). Thus, if A Corp. owned forty-nine percent of the value of the stock of B Corp., but directors were elected under a formula that assured that A Corp. could elect a majority of the directors of B Corp., I.R.C. § 631(c) treatment would not apply to royalties paid under a coal lease between A Corp. and B Corp. But if A corp. could not control the board of directors of B Corp., I.R.C. § 631(c) would be available. *See* Rev. Rul. 71-140, 1971-1 C.B. 161 (iron ore lease from shareholder corporation to "captive" mining corporation of which it owned one-third of the stock).

The unavailability of capital gains treatment for royalties under coal leases between related parties applies to coal mined after September 30, 1985, regardless of the date of the lease. Tax Reform Act of 1984, § 178(b)(1); H.R. Rep. No. 861, 98th Cong., 2d Sess., 1036. An exception is made, however, for coal sold before January 1, 1990 under a fixed contract in effect on June 15, 1984, under which the royalties due the lessor cannot be adjusted to reflect the increased income tax liability of the royalty holder that would result if the rule were applied. Tax Reform Act of 1984, § 178(b)(2); H.R. Rep. No. 861, 98th Cong., 2d Sess. 1036 (1984).

D. Recapture Items

The disposition by either sale or lease of a mineral property (solid mineral, oil, or gas) may result in recapture of items previously expensed with respect to the property. Some of the recapture rules apply to sales but not to leases.

For properties placed in service prior to January 1, 1987 recapture was fairly limited, but was significant when it occurred because recapture income was ordinary income and the balance of the gain would be I.R.C. § 1231 gain eligible for the capital gains preference. Prior to 1987 recapture was generally limited to the following situations:

(a) IDC for oil and gas properties are subject to recapture under I.R.C. § 1254. *See* Part VI.A.5, *supra*.

(b) Previously expensed solid mineral exploration expenses are subject to recapture under I.R.C. § 617(d)(1). *See* Part V.B.5.(b), *supra*.

(c) If a mineral lease transfers title to equipment, a bonus may be allocated to the sales price of the equipment, *see Choate v. Commissioner*, 324 U.S. 1 (1945); *Louisiana Land & Exploration Co. v. Commissioner*, 6 T.C. 172 (1946) (*acq.*) and thereby trigger I.R.C. § 1245 recapture. Section 1245 recapture may also apply, for example, to the capitalized costs of drilling and equipping an oil well that were not deductible as IDC. There may also be Investment Tax Credit recapture under I.R.C. § 47.

For properties placed in service after December 31, 1986 recapture under I.R.C. § 1254 is significantly expanded. For sales after 1986, however, recapture is of more limited importance in light of the repeal of the capital gains preference (except to the extent of the transitional allowance of a limited capital gains preference under I.R.C. § 1(j) for gain recognized in 1987). It is not, however, totally insignificant, as capital gains and losses continue to be subject to a number of rules different from ordinary income, including the limitation on the deductibility of capital losses. Corporations may deduct capital losses only to the extent of capital gains. I.R.C. § 1211(a). Individuals can deduct capital losses to the extent of capiatl gains, plus $3,000 of capital looses may be deducted against ordinary income. I.R.C. § 1211(b).

Section 1254, as amended by the Tax Reform Act of 1986, treats as ordinary income on the disposition of any mineral property (both solid mineral and oil and gas) the lesser of (1) the gain realized (or the excess of the fair market value of the property over the adjusted basis if the disposition is not a realization event) or (2) the sum of the following items: (a) depletion under I.R.C. § 611 (which includes both cost and percentage depletion) to the extent that depletion reduced the basis of the property; (b) solid mineral exploration expenses that were deducted under I.R.C. § 617 with respect to the property and which were not included in the basis of the property; (c) solid mineral development expenses incurred with respect to the property that were deducted under I.R.C. § 616; and (d) in the case of oil and gas properties, all IDC deducted with respect to the property under I.R.C. § 263(c). For this purpose, solid mineral exploration and development expenses and oil and gas IDC deducted by a corporation pursuant to I.R.C. § 291(b) are treated as if they were deducted under I.R.C. §§ 616, 617, or I.R.C. § 263(c), and thus are recaptured. *See* I.R.C. § 291(b)(2). A similar rule applies to expenses deducted over the optional ten-year period provided in I.R.C. § 59(e).

Section 1254 recapture is subject to the same exceptions that apply to I.R.C. § 1245 recapture. Special rules are provided to determine the amount of recapture income if the taxpayer disposes of less than the entire interest in the property. *See* Part VI.A.5, *supra*.

Section 1254, as amended by the Tax Reform Act of 1986, does not apply to any property acquired pursuant to a contract entered into before September 16, 1986 and which was binding at all times thereafter.

X. CHOICE OF OPERATING ENTITY AND PASSIVE LOSS RULES

A. *Generally*

The choice of the optimal business entity for operating an extractive enterprise is extraordinarily complex. Nontax considerations may indicate that a corporation is desirable in one case while a partnership or joint venture may be better suited for another enterprise. In addition to these broadly used forms of business organization, the oil and gas industry traditionally has used more flexible arrangements such as pooling arrangements and farmouts, both of which have their origins in nontax planning. There are, however, significant tax problems attendant to these arrangements. For thorough discussion *see* Parker, *Contribution of Services to the Pool of Capital: General Counsel Memorandum 22730 to Revenue Ruling 83-46*, 35 Annual Institute on Oil and Gas Taxation Law 313 (1984); Linden, *Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine*, 33 Tax Lawyer 115 (1979). No single form of organization is optimal from a tax perspective. In one case a partnership might be best; in another a corporation may be best. From a tax perspective, there is the added complexity of deciding whether to use an S Corporation, which offers the nontax benefits of incorporation but the operating income which is taxed more like that of a partnership than a corporation. When selecting partnership organization form, consideration must be given to whether to organize a limited partnership or a general partnership. There are nontax considerations in this decision, but significant tax impacts also flow from the choice.

B. *Organization*

Except when proven oil and gas properties are involved, the tax consequences of organizing the entity rarely are determinative. *See* Part I.B.3.(b), *supra*. The organization of corporations (both C Corporations and S Corporations) is generally tax free under I.R.C. § 351. One exception is the contribution of property subject to a mortgage in excess of basis; the excess is taxable income. I.R.C. § 357(c).

The organization of a partnership generally is tax free under I.R.C. §§ 721-723. Similarly to the organization of a corporation, but with some differences, the organization of a partnership can result in the recognition of gain if a partner is relieved of liabilities in excess of the basis of property contributed to the partnership. A contributing partner, however, is not relieved of all liabilities assumed by the partnership, but only those in excess of his share of liabilities as a partner. *See* Treas. Reg. § 1.722 -1, (Ex. 2).

C. Operating Income

1. C Corporations

The operating income of C Corporations is taxed to the corporation at the rates specified in I.R.C. § 11. Although the nominal highest marginal rate is thirty-four percent, applying to incomes in excess of $75,000, a five percent surtax applies to corporate income between $100,000 and $335,000, thus creating a disguised thirty-nine percent bracket "hump." If a corporation incurs a net operating loss, it may not be deducted by its shareholders, but instead is carried back or forward under I.R.C. § 172. Profits are taxed again to the shareholders when they are distributed as dividends, I.R.C. § 301, or upon liquidation, I.R.C. § 331. In addition, the corporation recognizes gain upon the distribution of appreciated property in a nonliquidating distribution (*e.g.*, dividend or redemption), I.R.C. § 311; and it recognizes gain upon the distribution of property in liquidation. I.R.C. § 336.

C Corporations are not subject to the passive loss rules of I.R.C. § 469 unless more than fifty percent of the stock is held during the last half of the taxable year by five or fewer individuals. *See* I.R.C. § 469(j)(1) (Personal service corporations are also subject to I.R.C. § 469.) Even if such a closely held corporation is subject to I.R.C. § 469, the passive loss rules do not prohibit deducting passive losses against business income. Passive losses may not be deducted against investment income, such as dividends, interest, royalties, and gains from investment property. *See* I.R.C. § 469(e)(2).

The corporate minimum tax under I.R.C. § 55 is a major consideration. It includes as a preference item one half of the amount by which book income exceeds alternative minimum taxable income (before taking this prefernece item into account). I.R.C. § 56(f).

2. S Corporations

The operating income and gains from the sale of property of S Corporations generally is taxed directly to the shareholders under I.R.C. § 1366. The corporation is not taxed except on certain gains on the sale of property (including inventory), I.R.C. § 1374, and passive investment income, I.R.C. § 1375. Neither of these rules applies to a corporation that has always been an S Corporation. If an S Corporation incurs a net operating loss, it passes through to the shareholders, who may deduct the loss on their own returns. Losses may be deducted, however, only to the extent of the shareholder's basis in stock of the S Corporation and loans to the S Corporation. I.R.C. § 1366(d). Disallowed losses may be carried over.

Eligibility to elect S Corporation status is limited by the conditions in I.R.C. § 1361. The most important restrictions are: (1) the limitations of shareholders to individuals (and a few narrowly prescribed types of trusts); (2) the limitation of the number of shareholders to thirty-five (counting husband and wife as one shareholder); and (3) the requirement that the corporation have only one class of stock (although nonvoting common that is identical to voting common in all other respects is permitted).

S Corporations are not subject to the corporate alternative minimum tax. Instead the shareholders are subject to the individual alternative minimum tax based on all of their income, including their share of the S Corporation's income. For this, and for other purposes, the character of each item entering into the S Corporation's taxable income flows through to the shareholders. I.R.C. § 1366(b).

S Corporations are not subject to the passive loss rules of I.R.C. § 469 in their corporate capacity. Instead the passive loss rules are applied to the shareholders of the S Corporation in essentially the same manner that the passive loss rules apply to partners.

Because S Corporations are flow-through entities like partnerships, the use of S Corporations is much more attractive from a tax perspective than it was before the Tax Reform Act of 1986. With the maximum individual marginal tax rate nominally at twenty-eight percent, subject to a five percent surtax that creates a real maximum marginal rate of thirty-three percent (*see* I.R.C.

§ 1), in many instances the individual tax rate is less than the corporate rate. In addition, the elimination of the capital gains preference has largely eliminated a "tax bail out" through sale of corporate stock following the retention and accumulation of corporate earnings. Thus, in today's tax climate, organization as a flow-through entity generally is more desirable than organization as a C Corporation.

3. Partnerships

Partnerships are not tax paying entities. The income, gains, and losses of a partnership are passed through to the partners according to their distributive shares. I.R.C. §§ 701-704. Partners may deduct partnership losses only to the extent of their basis in the partnership, I.R.C. § 704(d), but a partner's basis in his partnership interest includes his share of partnership liabilities. *See* I.R.C. § 752(a); Treas. Reg. § 1.752-1(a),-(1)(e). Limited partners do not share in partnership liabilties, unless the debt is nonrecourse. If the debt is nonrecourse, limited partners share in the debt relative to their profit percentages for purposes of determining basis, but their ability to claim deductions founded on the nonrecourse debt may be limited by the at-risk rules of I.R.C. § 465.

After the Tax Reform Act of 1986, partnership form is relatively more attractive than C Corporation form for the same reasons that S Corporation status, *discussed supra*, is more attractive than C Corporation status. Partnership form has long been preferred to corporate form for enterprises that were expected to generate tax losses (including real losses incurred in start up periods). This applied as well to the choice between partnership form and S Corporation form because of technical differences in the rules governing the basis limitation on loss flow-throughs. These advantages of partnership form continue under the Internal Revenue Code of 1986, but they are mitigated by the application of the passive loss rules of I.R.C. § 469.

Section 469 applies to partners to restrict their ability to deduct losses generated by a partnership in which they do not materially participate. Limited partners are deemed not to materially participate, except under limited circumstances specified in the regulations. I.R.C. § 469(h)(2). Temp. Reg. § 1.469-5T(a), (3). it is most important to note that I.R.C. § 469 applies as well to general partners that do not materially participate in the business affairs of the partnership as well.

D. *Passive Loss Rules*

1. Deferral of Losses

Section 469 disallows the deduction by individuals, including partners and shareholders in S Corporations of aggregate losses from passive activities in excess of aggregate net income from passive activities in any taxable year. I.R.C. § 469(a)(1). Thus losses from passive activities are segregated and may not be deducted against salary income, interest, dividends, royalties, active business income, or gains from the sale of property producing such income. *See* I.R.C. § 469(e)(1). The net income or loss from each passive activity must be separately determined before aggregation of losses and income. Temp. Reg. § 1.469-1T(f)(2). Disallowed losses must then be traced back proportionately to the activities that gave rise to them. *Id.* Suspended losses are carried over and enter into the next year's computation on a rolling basis; the carryover period is unlimited. *See* I.R.C. § 469(b). Suspended losses of a particular activity may be deducted in the year that the activity is sold. *See* I.R.C. § 469(g)(1). Disposition of a passive activity other than by taxable sale generally does not allow full deduction of the suspended losses. Special rules are provided to allow suspended losses for installment sales of passive activities over the period that the installment gain is recognized. *See* I.R.C. § 469(g)(3).

2.Definitions

(a) Passive Activity

A passive activity is any activity that involves the conduct of a trade or business, in which the taxpayer does not materially participate. I.R.C. § 469(c)(1). (A special rule treats as passive all rental activities.) Thus, for example, a general partner in a mining partnership who does not materially participate in the business is subject to I.R.C. § 469 with respect to losses incurred by the partnership. This can totally negate deductions otherwise allowable. For example, assume that the partnership incurred $100,000 of mine development expenses otherwise deductible under I.R.C. § 616, and that the passive partner's distributive share of these expenses was $10,000. If the partner had no passive activity income from other sources for the year, none of the $10,000 would be deductible that year.

Holding royalty interests is not a passive activity unless they are held as part of a trade or business. I.R.C. § 469(e)(7)(A). Section 469(c)(6), however, gives the Treasury authority to bring such activites within the sweep of I.R.C. § 469.

(b) Working Interests in Oil and Gas Property: Special Rule

Section 469(c)(3) provides a special rule applicable only to working interests in an oil and gas property. Under this rule a working interest in an oil and gas property that the taxpayer holds directly or through an entity that does not limit his liability with respect to such interest is deemed not to be a passive activity even if the taxpayer does not materially participate. Thus, any general partner in a partnership holding a working interest is not subject to the passive loss rules with respect to the working interest. The primary benefit of this rule is to permit the deduction under I.R.C. § 263(c) of IDC without limitation under I.R.C. § 469. All limited partners, however, will be subject to the passive loss rules with respect to the working interest; thus potential to deduct IDC is restricted. As a result, limited partnerships are now a much less desirable form of organization for exploratory ventures. As far as S Corporations are concerned, because the corporate form limits liability, the special rule for working interests does not apply. But a shareholder of an S Corporation that holds an oil and gas working interest will not be subject to I.R.C. § 469 if he materially participates. Only limitations on liability arising from the form of entity conducting the activity are taken into account. Thus, factors such as an indemnification or stop-loss agreement and insurance are not taken into account. Temp. Reg. § 1.469-1T(e)(4)(v).

Section 469(c)(3)(B) provides that if any losses from a property are treated as active under this rule, all income from the property in future years must be treated as active income. Temp. Reg. § 1.469-2T(c)(6) implements this rule in such a manner that a taxpayer who realizes active losses as a general partner in developing one lease overlying a particular reservoir may have income from a limited partnership interest which develops another tract overlying the same reservoir recharacterized as active income. *See* Temp. Reg. §1.469-2T(c)(6)(iv), (Ex. 1).

See generally White, *How the Passive Loss Limitation Rules Will Affect Working Interests*, 67 J. Tax. 138 (1987).

(c) Material Participation

Material participation in an activity requires that the taxpayer be involved in the operations of the activity on a "regular, continuous, and substantial basis." I.R.C. § 469(h)(1). The regulations provide detailed mechanical tests for determining material participation by counting the number of hours devoted to the activity by the taxpayer. A taxpayer materially participates in an activity if he meets any of the following tests: (1) he devoted more than 500 hours to the activity in the year; (2) his participation constitutes all of the participation in the activity of any indiviudal; (3) he participates in the activity for more than 100 hours during the year and his participation is not less than that of any other individual; (4) the activity is a trade or business, he participates in the activity for more than 100 hours (but not more than 500 hours) during the year, and his total participation in all such trade or business activities during the year exceeds 500 hours; (5) he materially participated in the activity for five of the preceding ten taxable years; (6) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years; or (7) based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis. Temp. Reg. § 1.469-5T(a)(1). Qualifying under the facts and circumstances test is subject to speical restrictions. First, participation in an activity for 100 hours or less during the year can never qualify as material participation under this test. Temp. Reg. § 1.469-5T(b)(2)(ii). Second, management services are taken into account in determining material participation only if no person other than the taxpayer receives compensation for managing the activity, or no other person devotes more time to managing the activity than the taxpayer does. Temp. Reg. § 1.469-5T(b)(2)(ii).

The regulations provide a special rule dealing with "significant participation activities." This rule is not found in the statute, but has been promulgated under the broad regulatory authority of I.R.C. § 469(l)(B). Temp. Reg. § 1.469-1T(f)(2)(i)(C). A "significant participation activity" is any activity in which the taxpayer participates for more than 100 hours during the year, but in which he does not materially participate. If gross income for the year from all significant participation activities exceeds passive activity deductions from such activities, all of the activities are aggregated into a single passive activity for the year. A portion of the income from the aggregated activities is then recharacterized as active rather than passive income.

(d) Activity

Section 469 does not define the term "activity." This is, however, one of the most important determinations in applying I.R.C. § 469. If that term is broadly defined, then material participation in one business undertaking might be a basis for claiming the right to deduct losses in another undertaking in which the taxpayer did not materially participate. If too narrowly defined, then material participation in one phase of an integrated business might not support deductions for losses incurred in another phase of the business.

For example, if one partner supervises a mining operation and another partner supervises the application of nonmining processes to the extracted mineral, and it is ascertained that the mining segment of the business operated at a loss and the processing segment operated at at profit, may both partners amalgamate the loss and profit of the respective operations? If "activity" is narrowly defined, the manager of the mine may deduct his active loss against his passive income from the processing, but the manager of the processing operation may not deduct his passive loss from the mine against his active income from the processing. A similar problem would arise if one partner managed a profitable mine and the other managed a mine that ran at a loss.

No regulations delineating the scope of an activity have been published. The "Bluebook," drawing on the legislative history, states that "[t]he determination of what constitutes a separate activity is intended to be made in a realistic economic sense."

Undertakings that consist of a single integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss" should be a single activity. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 245-46 (1987).

The various business undertakings of a single partnership or S Corporation may constitute any number of activities for purposes of I.R.C. § 469. The manner in which the entity characterizes them is not determinative. That two undertakings are conducted by different partnerships or S Corporations is not determinative; the undertakings of different entities may be consolidated to identify an activity. Although I.R.C. § 183 (hobby losses) and I.R.C. § 465 (at risk) both involve similar issues and may be helpful, the rules for identifying an activity under those sections are not determinative. The test will be a facts and circumstances test.

Of particular interest in the extractive industries is the relevance of the property concept under I.R.C. § 614 in identifying activities. Clearly, the scope of a single activity under I.R.C. § 469 should not be talismanically linked to the determination of separate mineral properties under I.R.C. § 614. Under I.R.C. § 614 multiple mineral properties can be operated as a single mine. The mine, at the very least, should be the activity. Conversely, several mines may be aggregated into a single property if they constitute an "operating unit." This test requires some administrative and operational linkage wholly apart from taxes. Thus it may be of some weight, but probably will not be determinative.

As far as oil and gas are concerned, the term "activity" probably should not be applied on a well-by-well basis. In many instances it may be appropriate to apply it on a property-by—property basis. But if a single economic undertaking involves development of several leases but only one deposit (or several horizontal strata), perhaps a property-by-property approach would be too narrow. Determing the scope of each "activity" may be a troublesome question for many years.

CONCLUSION

This article has attempted to provide a general overview of most of the fundamental principals unique to taxation of mining and oil and gas extraction. Despite its bulk, many issues have been dealt with only tangentially or not at all. Most of these omitted issues, however, tend to be the more technical and narrow points of natural resource taxation, rather than general principles. In addition, this article is confined primarily to those issues that have been squarely addressed by the I.R.S. and the courts. This presents only a partial view, because there is a significant body of "lore" of taxation of natural resources that in everyday practice is important to tax administration and practice in this area.

I hope that neophytes to this arcane areas of law find this exposition helpful in getting their bearings. Both students and practitioners should be able to find some guidance in these pages. More experienced hands in natural resource taxation will not find much new here, except for a few of my opinions as to the logic or wisdom of a particular statutory provision, regulation, ruling, or court decision. The purpose of this article was not to examine the troublesome unanswered questions, but to describe the basic pattern and interrelationships of the various provisions of Subchapter I of the Internal Revenue Code and to highlight major inconsistencies and problem areas. Thus, I hope that everyone, regardless of his level of experience, may find something useful in this work.